Pillsbury's own restructuring proposal compared unfavorably in value to a hostile all-cash, all-shares offer from Grand Met. To be sure, these cases were expressly disapproved by the Delaware Supreme Court in dicta in *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989) (*Time-Warner*), excerpted below. The most recent and significant case dealing with this issue, the 2011 *Airgas* opinion, a "just say no" case, is noted below, following a discussion of the Delaware Supreme Court opinion in the *Time-Warner* case.

4. As we have said, many institutional investors have long been skeptical of poison pills. Precatory shareholder resolutions to redeem rights plans have for many years been among the most common subjects of Rule 14(a)(8) shareholder proxy access proposals. As a gesture to investor interests, many firms today have allowed their pills to expire. But they have done so knowing that they can put a new pill in place in less than 24 hours should a hostile acquirer approach.

13.4 Choosing a Merger or Buyout Partner: *Revlon*, Its Sequels, and Its Prequels

The board's entrenchment interest can affect not only its takeover defenses but also its choice of a merger or buyout partner. Management can obtain a variety of benefits in "friendly" deals, ranging from such minor things as a place on the surviving corporation's board, to more significant benefits such as consulting contracts, termination payments, and other compensation-related benefits. Traditionally, corporate law treated decisions to initiate merger proposals as business judgments as long as management did not have a conflicting ownership interest. In its third revolutionary takeover opinion of the 1985-1986 season, the Delaware Supreme Court addressed the board's fiduciary duty in arranging for the "sale" of a company. The case was *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). Even before *Revlon*, however, the Delaware Supreme Court signaled its concern about the possibility that incumbent managers might sell their company at a low price to a favored bidder in the remarkable case of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). At the time it was issued, the *Van Gorkom* opinion was believed to be an aggressive articulation of the board's general duty of care. (Accordingly, we noted the case in Chapter 7.) In hindsight, however, *Van Gorkom* has come to seem much more like a precursor of the great Delaware takeover cases of the mid-1980s, and especially of *Revlon*. We reproduce portions of this very lengthy opinion below.

SMITH v. VAN GORKOM

488 A.2d 858 (Del. 1985)

Horsey, J.:

This appeal from the Court of Chancery involves a class action brought by shareholders of the defendant Trans Union Corporation ("Trans Union" or "the Company"), originally seeking rescission of a cash-out merger of Trans Union into . . . a wholly-owned subsidiary of the defendant, Marmon Group, Inc. ("Marmon"). Alternate relief in the form of damages is sought against the defendant members of the Board of Directors of Trans Union. . . .

Trans Union was a publicly-traded, diversified holding company, the principal earnings of which were generated by its railcar leasing business. During the period here involved, the Company had a cash flow of hundreds of millions of dollars annually. However, the Company had difficulty in generating sufficient taxable income to offset increasingly large investment tax credits (ITCs). Accelerated depreciation deductions had decreased available taxable income against which to offset accumulating ITCs. . . .

[At a senior management meeting on September 5, 1980, Trans Union's CFO and COO discussed a leveraged buyout as a solution to the ITC problem.] . . . They did not "come up" with a price for the Company. They merely "ran the numbers" [and t]heir "figures indicated that $50 would be very easy to do but $60 would be very difficult to do under those figures." This work did not purport to establish a fair price for either the Company or 100% of the stock. It was intended to determine the cash flow needed to service the debt that would "probably" be incurred in a leveraged buy-out. . . .

. . . Van Gorkom [Trans Union's CEO for more than 17 years] stated that he would be willing to take $55 per share for his own 75,000 shares. [Nevertheless, h]e vetoed the suggestion of a leveraged buy-out by Management . . . as involving a potential conflict of interest for Management. . . . It is noteworthy in this connection that he was then approaching 65 years of age and mandatory retirement.

For several days following the September 5 meeting, Van Gorkom pondered the idea of a sale. . . .

Van Gorkom [then] decided to meet with Jay A. Pritzker, a well-known corporate takeover specialist and a social acquaintance. However, rather than approaching Pritzker simply to determine his interest in acquiring Trans Union, Van Gorkom assembled a proposed per share price for sale of the Company and a financing structure by which to accomplish the sale. Van Gorkom did so without consulting either his Board or any members of Senior Management except one: Carl Peterson, Trans Union's Controller. Telling Peterson that he wanted no other person on his staff to know what he was doing, but without telling him why, Van Gorkom directed Peterson to calculate the feasibility of a leveraged buy-out at an assumed price per share of $55. Apart from the Company's historic stock market price,[5] and Van Gorkom's long association with Trans Union, the record is devoid of any competent evidence that $55 represented the per share intrinsic value of the Company. . . .

5. The common stock of Trans Union was traded on the New York Stock Exchange. Over the five year period from 1975 through 1979, Trans Union's stock had traded within a range of a high of $39½ and a low of $24¼. Its high and low range for 1980 through September 19 (the last trading day before announcement of the merger) was $38¼-$29½.

Van Gorkom arranged a meeting with Pritzker at the latter's home on Saturday, September 13, 1980. Van Gorkom [suggested $55 per share as the price and how to potentially finance it. Pritzker subsequently made a cash offer for Trans Union at $55/share. The offer was to remain open for a period of 90 days, during which Trans Union could accept a higher offer. But this "market test" was defective in the court's view.] . . .

On Friday, September 19 [1980], Van Gorkom called a special meeting of the Trans Union Board for noon the following day. . . .

Ten directors served on the Trans Union Board, five inside . . . and five outside. . . . None was an investment banker or trained financial analyst. All members of the Board were well informed about the Company and its operations as a going concern. . . .

Van Gorkom began the Special Meeting of the Board with a twenty-minute oral presentation. Copies of the proposed Merger Agreement were delivered too late for study before or during the meeting. He reviewed the Company's ITC and depreciation problems and the efforts theretofore made to solve them. He discussed his initial meeting with Pritzker and his motivation in arranging that meeting. Van Gorkom did not disclose to the Board, however, the methodology [for arriving] at the $55 figure, or . . . that he first proposed the $55 price [to] Pritzker.

Van Gorkom outlined the terms of the Pritzker offer as follows . . . for a period of 90 days, Trans Union could receive, but could not actively solicit, competing offers; the offer had to be acted on by the next evening, Sunday, September 21; Trans Union could only furnish to competing bidders published information, and not proprietary information; the offer was subject to Pritzker obtaining the necessary financing by October 10, 1980; if the financing contingency were met or waived by Pritzker, Trans Union was required to sell to Pritzker one million newly-issued shares of Trans Union at $38 per share.

Van Gorkom took the position that putting Trans Union "up for auction" through a 90-day market test would validate a decision by the Board that $55 was a fair price. He framed the decision before the Board not as whether $55 per share was the highest price that could be obtained, but as whether the $55 price was a fair price that the stockholders should be given the opportunity to accept or reject. . . .

On Monday, September 22, the Company issued a press release announcing that Trans Union had entered into a "definitive" Merger Agreement with an affiliate of the Marmon group, Inc., a Pritzker holding company. Within 10 days of the public announcement, dissent among Senior Management over the merger had become widespread. Faced with threatened resignations of key officers, Van Gorkom met with Pritzker who agreed to several modifications of the Agreement. Pritzker was willing to do so provided that Van Gorkom could persuade the dissidents to remain on the Company payroll for at least six months after consummation of the merger. . . .

The next day, October 9, Trans Union issued a press release announcing [the deal, Pritzker satisfying the financing commitment, and] that Trans Union was now permitted to actively seek other offers and had retained Salomon Brothers for that purpose. [Further] if a more favorable offer were not received before February 1, 1981, Trans Union's shareholders would thereafter meet to vote on the Pritzker proposal.

It was not until the following day, October 10, that the actual amendments were delivered to Van Gorkom for execution. [T]he amendments were considerably at variance with Van Gorkom's representations . . . to the Board on October 8; and the amendments placed serious constraints on Trans Union's ability to negotiate a better deal and withdraw from the Pritzker agreement. Nevertheless, Van Gorkom proceeded to execute [them] without conferring further with the Board . . . and apparently without comprehending [their] actual implications. . . .

Salomon Brothers' efforts over a three-month period from October 21 to January 21 produced only one serious suitor for Trans Union — General Electric Credit Corporation ("GE Credit"), a subsidiary of the General Electric Company. However, GE Credit was unwilling to make an offer for Trans Union unless Trans Union first rescinded its Merger Agreement with Pritzker. When Pritzker refused, GE Credit terminated . . . discussions . . . in early January. . . .

On February 10, the stockholders of Trans Union approved the Pritzker merger proposal. . . .

On [this] record . . . , we must conclude that the Board of Directors did not reach an informed business judgment on September 20. . . .

Without any documents before them concerning the proposed transaction, the members of the Board were required to rely entirely upon Van Gorkom's 20-minute oral presentation of the proposal. No written summary of the . . . merger was presented; the directors were given no documentation to support the adequacy of $55 price per share . . . ; and the Board had before it nothing more than Van Gorkom's statement of his understanding of the substance of an agreement which he admittedly had never read. . . .

A substantial premium may provide one reason to recommend a merger, but in the absence of other sound valuation information, the fact of a premium alone does not provide an adequate basis upon which to assess the fairness of an offering price. . . .

Indeed, as of September 20, the Board had no other information [besides its current and historical stock price] on which to base a determination of the intrinsic value of Trans Union as a going concern. As of September 20, the Board had made no evaluation of the Company designed to value the entire enterprise. . . . Thus, the adequacy of a premium is indeterminate unless it is assessed in terms of other competent and sound valuation information that reflects the value of the particular business. . . .

This brings us to the post-September 20 "market test" upon which the defendants . . . rely to confirm the reasonableness of their September 20 decision to accept the Pritzker proposal. . . .

Again, the facts of record do not support the defendants' argument. There is no evidence: (a) that the Merger Agreement was effectively amended [on September 20] to give the Board freedom to put Trans Union up for auction sale to the highest bidder; or (b) that a public auction was in fact permitted to occur. . . .

The October 10 amendments to the Merger Agreement did authorize Trans Union to solicit competing offers, but the amendments had more far-reaching effects. The most significant change was in the definition of the third-party "offer" available to Trans Union as a possible basis for withdrawal from its Merger Agreement with Pritzker. Under the October 10 amendments, a better *offer* was no longer sufficient to permit Trans Union's withdrawal. Trans Union was now permitted to . . . abandon the merger only if, prior to February 10, 1981, Trans Union had either consummated a merger (or sale of assets) with a third party or had entered into a "definitive" merger agreement more favorable than Pritzker's and for a greater consideration — subject only to stockholder approval. . . .

Finally, we turn to the Board's meeting of January 26, 1981 . . . [which] was the first meeting following the filing of the plaintiffs' suit in mid-December and the last meeting before the previously-noticed shareholder meeting of February 10. . . .

The defendants characterize the Board's Minutes of the January 26 meeting as a "review" of the "entire sequence of events" from Van Gorkom's initiation of the negotiations on September 13 forward. The defendants . . . argue that whatever information the Board lacked to make a deliberate and informed judgment on September 20, or on October 8, was fully divulged to the entire Board on January 26. Hence, the argument goes, the Board's vote on January 26 to again "approve" the Pritzker merger must be found to [be] an informed and deliberate judgement. . . .

We must conclude from the foregoing that the Board was mistaken as a matter of law regarding its available courses of action on January 26, 1981. . . . [T]he Board had but two options: (1) to proceed with the merger and the stockholder meeting, with the Board's recommendation of approval; *or* (2) to rescind its agreement with Pritzker, withdraw its approval of the merger, and notify its stockholders that the proposed shareholder meeting was canceled. There is no evidence that the Board gave any consideration to these, its only legally viable [options].

But the second course of action . . . clearly involved a substantial risk — that the Board would [face] suit by Pritzker for breach of contract based on its September 20 agreement as amended October 10. As previously noted, under the terms of the October 10 amendment, the Board's only ground for release from its agreement with Pritzker was its entry into a more favorable definitive agreement to sell the Company to a third party. Thus, in reality, the Board was not "free to turn down the Pritzker proposal" . . . on January 26 by simply relying on its self-induced failure to [reach] an informed business judgment at the time of its original agreement. . . .

The defendants ultimately rely on the stockholder vote of February 10 for exoneration. The defendants contend that the stockholders' "overwhelming" vote approving the Pritzker Merger Agreement [cured] any failure of the Board to reach an informed business judgment. . . .

[W]e find that Trans Union's stockholders were not fully informed of all facts material to their vote on the Pritzker Merger and that the Trial Court's ruling to the contrary is clearly erroneous. . . .

We conclude that the Board acted in a grossly negligent manner on October 8 [in addition to acting in a grossly negligent manner at the initial meeting on September 20 — Eds.]; and that Van Gorkom's representations on which the Board based its actions do not constitute "reports" under §141(e) on which the directors could reasonably have relied. . . .

JAY PRITZKER & JEROME VAN GORKOM

Jay Pritzker was born into a family already prominent in Chicago's business circles. His father, an immigrant from the Ukraine, had arrived in Chicago at the turn of the century with little money and no knowledge of the English language. In time, he went to law school and opened a law office. Gradually he began investing in area businesses and found great success.

At the precocious age of 14, his son, Jay, graduated from high school and began his studies at Northwestern University. After obtaining a law degree from Northwestern and performing military service during World War II, he returned home to join his father at Pritzker & Pritzker and helped manage the family investments. He formed what would become The Marmon Group in 1953 with his brother Robert in order to purchase underperforming industrial companies. Jay Pritzker was known for his ability to swiftly evaluate business deals and his preference for quick and simple transactions. As he told the *Wall Street Journal*, "We've bought a lot of things on just a handshake or a paragraph or two. We're the least legal-minded people you'll ever meet."[25] His investments made him and his family billionaires.

While vacationing at a ski chalet in the Swiss Alps, Jay Pritzker met Jerome Van Gorkom, CEO of Trans Union. Both men were active in the Chicago business community and became friends while working together to rescue the Chicago public school system from severe financial difficulties. Their relationship would lead to a merger of their respective companies and to a groundbreaking legal decision in *Smith v. Van Gorkom.*

NOTE ON SMITH v. VAN GORKOM

As noted above, *Smith v. Van Gorkom* is on its own terms a case about the extent of the directors' duty of care. Yet as argued in Chapter 7, courts generally refuse to examine the reasonableness of decisions made by disinterested directors in the board's regular decision-making process. (Recall the *Kamin* case in particular.) *Smith v. Van Gorkom* was a jolting break with this tradition — so much so that we are persuaded it is something other than the simple application of duty of care doctrine to special facts.[26] In particular, we recommend the interpretation offered by Professors Jonathan Macey and Geoffrey Miller that *Van Gorkom* should be understood *not* as a director negligence case (although the court presented it this way) but rather as the first of several important cases in which the court struggled to construct a new standard of judicial review for "change in control" transactions such as mergers.[27]

25. Quoted in William Owen, Autopsy of a Merger (1986).

26. We are unaware of any prior nonbanking case in which directors who have no conflicting interests and who attend meetings and deliberate before authorizing a transaction are held personally liable for breach of a duty of care, let alone a case in which they are held liable for approving a sale of the company at a 50 percent premium to market price.

27. See Jonathan R. Macey & Geoffrey P. Miller, Trans Union *Reconsidered*, 98 Yale L.J. 127, 138 (1988). We stand behind our conviction by locating an excerpt from *Van Gorkom* in this Chapter, rather than Chapter 7, although, of course, we do not object if some of our readers wish to read *Van Gorkom* in conjunction with Chapter 7.

NOTE: INTRODUCING THE REVLON *DECISION*

The opinion that gave full cry to the courts' desire to modify the business judgment rule in the context of transactions that involved a change in control was the ***Revlon*** decision, which was handed down the year following ***Van Gorkom***. The bidder in ***Revlon*** was Ronald O. Perelman, a well-known takeover entrepreneur and the chairman of Pantry Pride, Inc. Revlon's management opposed the Perelman/Pantry Pride offer with two defensive tactics. First, it adopted a form of the flip-in rights plan as described above, and second, it repurchased 20 percent of Revlon's stock with unsecured debt (the Notes) at a premium price. This repurchase had two useful effects from the standpoint of Revlon's embattled management. First, these Notes clouded Revlon's balance sheet and thus made it harder for Perelman to find financing to support his buyout. Second, the Notes gave management a vehicle for inserting a covenant that barred Revlon from selling or encumbering its assets without the approval of its independent directors. Again, such a covenant would make it more difficult for Perelman to borrow against Revlon's assets and subsequently pay down his debt by selling assets in typical leveraged buyout fashion.[28]

Perelman proved to be a formidable opponent, however. He countered management's moves by raising his bid price! Soon shareholder pressure on Revlon's board to act became overwhelming. At this point, Revlon's management attempted to reverse course by soliciting a competing bid from a "white knight," or friendly bidder, Forstmann Little & Co., a financial firm in the leveraged buyout business. The board's new strategy aimed at giving shareholders the cash they were demanding by selling Revlon to a friendly buyer (Forstmann and themselves) rather than to Perelman. But for the new strategy to succeed, Revlon had to remove the restrictive covenant contained in the Notes that it had exchanged with its shareholders, since this covenant not only interfered with Perelman's financing but also precluded Forstmann from financing the new alternative transaction. Yet one thing leads to another. Stripping the restrictive covenant from the Notes sharply lowered their value. Within days, lawyers representing Revlon's noteholders (who were erstwhile shareholders) were threatening to sue the board for bad faith and breach of duty.

Forstmann was persuaded to enter the fray and make a bid, but Perelman vowed to beat whatever price Forstmann would offer. Revlon then concluded a final deal with Forstmann: Revlon would assure Forstmann's victory by giving it a "lock-up option" to purchase Revlon's most valuable assets at a bargain price if another bidder (i.e., Perelman) were to acquire more than 40 percent of Revlon's stock. In exchange, Forstmann would increase its offer for Revlon's stock (to $57.25) and support the price of Revlon's Notes (thus satisfying any claims of noteholders).

28. A leveraged buyout is a transaction in which a buyer borrows cash that will be used to buy the equity of the target corporation. Repayment of the borrowing comes from the sale of the target's assets (breakup) or is secured by the target's assets.

In response to the new Revlon-Forstmann deal, Pantry Pride increased its offer to $58/share conditional on the lock-up being rescinded or declared invalid. It sought to enjoin Forstmann's lock-up option as well as the agreement not to assist buyers other than Forstmann in the Delaware courts. The Delaware Supreme Court (per Justice Moore) firmly rejected what it considered to be Revlon's attempt to "rig" the bidding, holding that when the sale of the company became "inevitable," "[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."

We pick up here with the Delaware Supreme Court opinion after the court approved Revlon's original defensive tactics that were designed to maintain its independence (the poison pill and the exchange offer). Justice Moore now turns to Revlon's decision to sell to Forstmann and the lock-up option.

REVLON, INC. v. MACANDREWS AND FORBES HOLDINGS, INC.

506 A.2d 173 (Del. 1986)

MOORE, J.:

[The Revlon board's focus on its agreement with Forstmann on] shoring up the sagging market value of the Notes in the face of threatened litigation . . . was inconsistent with . . . the directors' responsibilities at this stage of the developments. The impending waiver of the Notes covenants had caused the value of the Notes to fall, and the board was aware of the noteholders' ire as well as their subsequent threats of suit. The directors thus made support of the Notes an integral part of the company's dealings with Forstmann, even though their primary responsibility at this stage was to the equity owners.

The original threat posed by Pantry Pride — the break-up of the company — had become a reality which even the directors embraced. Selective dealing to fend off a hostile but determined bidder was no longer a proper objective. Instead, obtaining the highest price for the benefit of the stockholders should have been the central theme guiding director action. Thus, the Revlon board could not make the requisite showing of good faith by preferring the noteholders and ignoring its duty of loyalty to the shareholders. The rights of the former already were fixed by contract. . . . The noteholders required no further protection, and when the Revlon board entered into an auction-ending lock-up agreement with Forstmann on the basis of impermissible considerations at the expense of the shareholders, the directors breached their primary duty of loyalty.

The Revlon board argued that it acted in good faith in protecting the noteholders because *Unocal* permits consideration of other corporate constituencies. Although such considerations may be permissible, there are fundamental limitations upon that prerogative. A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders. *Unocal*, 493 A.2d at 955. However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.

Revlon also contended that . . . it had contractual and good faith obligations to consider the noteholders. However, any such duties are limited to the principle that one may not interfere with contractual relationships by improper actions. Here, the rights of the noteholders were fixed by agreement, and there is nothing of substance to suggest that any of those terms were violated. The Notes covenants specifically contemplated a waiver to permit sale of the company at a fair price. The Notes were accepted by the holders on that basis, including the risk of an adverse market effect stemming from a waiver. Thus, nothing remained for Revlon to legitimately protect, and no rationally related benefit thereby accrued to the stockholders. Under such circumstances we must conclude that the merger agreement with Forstmann was unreasonable in relation to the threat posed.

A lock-up is not per se illegal under Delaware law. . . . Current economic conditions in the takeover market are such that a "white knight" like Forstmann might only enter the bidding for the target company if it receives some form of compensation to cover the risks and costs involved. . . . However, while those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders' detriment. . . .

Recently, the United States Court of Appeals for the Second Circuit invalidated a lock-up on fiduciary duty grounds similar to those here. *Hanson Trust PLC, et al. v. ML SCM Acquisition Inc., et al.*, 781 F.2d 264 (2d Cir. 1986). . . .

In *Hanson Trust*, the bidder, Hanson, sought control of SCM by a hostile cash tender offer. SCM management joined with Merrill Lynch to propose a leveraged buy-out of the company at a higher price, and Hanson in turn increased its offer. Then, despite very little improvement in its subsequent bid, the management group sought a lock-up option to purchase SCM's two main assets at a substantial discount. The SCM directors granted the lock-up without adequate information as to the size of the discount or the effect the transaction would have on the company. Their action effectively ended a competitive bidding situation. The *Hanson* Court invalidated the lock-up because the directors failed to fully inform themselves about the value of a transaction in which management had a strong self-interest. . . .

The Forstmann option had a similar destructive effect on the auction process. Forstmann had already been drawn into the contest on a preferred basis, so the result of the lock-up was not to foster bidding, but to destroy it. The board's stated reasons for approving the transaction were: (1) better financing, (2) noteholder protection, and (3) higher price. As the Court of Chancery found, and we agree, any distinctions between the rival bidders' methods of financing the proposal were nominal at best, and such a consideration has little or no significance in a cash offer for any and all shares. The principal object, contrary to the board's duty of care, appears to have been protection of the noteholders over the shareholders' interests.

While Forstmann's $57.25 offer was objectively higher than Pantry Pride's $56.25 bid, the margin of superiority is less when the Forstmann price is adjusted for the time value of money. In reality, the Revlon board ended the auction in return for very little actual improvement in the final bid. The principal benefit went to the directors, who avoided personal liability to a class of creditors to whom the board owed no further duty under the circumstances. Thus, when a board ends an intense bidding contest on an insubstantial basis, and where a significant by-product of that action is to protect the directors against a perceived threat of personal liability for consequences stemming from the adoption of previous defensive measures, the action cannot withstand the enhanced scrutiny which *Unocal* requires of director conduct. See *Unocal*, 493 A.2d at 954-55.

In addition to the lock-up option, the Court of Chancery enjoined the no-shop provision as part of the attempt to foreclose further bidding by Pantry Pride. *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d at 1251. The no-shop provision, like the lock-up option, while not per se illegal, is impermissible under the *Unocal* standards when a board's primary duty becomes that of an auctioneer responsible for selling the company to the highest bidder. The agreement to negotiate only with Forstmann ended rather than intensified the board's involvement in the bidding contest.

It is ironic that the parties even considered a no-shop agreement when Revlon had dealt preferentially, and almost exclusively, with Forstmann throughout the contest. After the directors authorized management to negotiate with other parties, Forstmann was given every negotiating advantage that Pantry Pride had been denied: cooperation from management, access to financial data, and the exclusive opportunity to present merger proposals directly to the board of directors. Favoritism for a white knight to the total exclusion of a hostile bidder might be justifiable when the latter's offer adversely affects shareholder interests, but when bidders make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions. Market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity.[16] Thus, as the trial court ruled, the shareholders' interests necessitated that the board remain free to negotiate in the fulfillment of that duty.

The court below similarly enjoined the payment of the cancellation fee, pending a resolution of the merits, because the fee was part of the overall plan to thwart Pantry Pride's efforts. We find no abuse of discretion in that ruling. . . .

In conclusion, the Revlon board was confronted with a situation not uncommon in the current wave of corporate takeovers. A hostile and determined bidder sought the company at a price the board was convinced was inadequate. The initial defensive tactics worked to the benefit of the shareholders, and thus the board was able to sustain its *Unocal* burdens in justifying those measures. However, in granting an asset option lock-up to Forstmann, we must conclude that under all the circumstances the directors allowed considerations other than the maximization of shareholder profit to affect their judgment, and followed a course that ended the auction for Revlon, absent court intervention, to the ultimate detriment of its shareholders. No such defensive measure can be sustained when it represents a breach of the directors' fundamental duty of

16. The directors' role remains an active one, changed only in the respect that they are charged with the duty of selling the company at the highest price attainable for the stockholders' benefit.

care. See *Smith v. Van Gorkom*, Del. Supr., 488 A.2d 858, 874 (1985). In that context the board's action is not entitled to the deference accorded it by the business judgment rule. The measures were properly enjoined. . . .

RONALD PERELMAN & TED FORSTMANN

Born into a wealthy Philadelphia family, Ron Perelman sat in on his father's board meetings as a child and pored over financial statements in his teenage years. After graduating from the University of Pennsylvania's Wharton School, he learned the art of dealmaking while working for his father. In 1978, he moved to Manhattan with no job, but big ambitions. He started by acquiring Hatfield Jewelers and turning it around by selling off many of its underperforming assets. His investment holding company, MacAndrews & Forbes, proceeded to acquire several other companies, including Marvel Comics, First Nationwide Bank, Panavision, and Technicolor. Early on he developed a relationship with "junk bond king" Michael Milken, who financed many of his acquisitions, including Revlon. By installing new management, disposing of assets, and then selling firms at a profit, he became a billionaire. On Wall Street, he was known for his exceptionally aggressive style.

Ted Forstmann graduated from Yale and Columbia Law School, and eventually formed Forstmann Little in 1978. The firm, an innovator in leveraged buyouts, became enormously profitable by buying and selling companies such as Dr. Pepper Co. When junk bonds became popular, however, Forstmann increasingly found himself losing out on deals because he could not raise as much money as junk bond–financed competitors. Forstmann publicly extolled his "old-fashioned" approach to business, which involved avoiding junk bond financing and maintaining good relations with the management of acquired companies. In a column for the *Wall Street Journal* in 1988, he attacked the junk bond industry, writing that "today's financial age has become a period of unbridled excess with accepted risk soaring out of proportion to possible reward."

QUESTIONS AND NOTES ON REVLON

1. What fiduciary duty did Revlon's board violate — a duty of care or a duty of loyalty?

2. According to the court in *Revlon*, what must a board do when it is committed to entering an acquisition transaction with one of two suitors who are locked in a competitive bidding contest? Does your answer imply that Delaware law is ultimately committed to shareholder primacy in board decision making, notwithstanding the dicta in *Unocal* allowing boards to consider nonshareholder interests in evaluating the threat posed by a hostile takeover?

3. In the 1989 case *Barkan v. Amsted Industries, Inc.*,[29] the Delaware Supreme Court clarified the substantive requirements imposed by *Revlon*. The court affirmed the lower court holding that there is no single template

29. 567 A.2d 1279 (Del. 1989).

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.

is to accord corporate boards degrees of deference along a continuum. Where, as in *Revlon* itself, the merger consideration is cash, courts will not defer to the board's judgment to take less cash. Thus, in such instances, any "deal protection" accorded to the favored merger partner will be closely reviewed to assure it represents a good-faith effort to get the best current price. By contrast, where, as in *Santa Fe*, the consideration is stock of a company of approximately equal size (that is, a situation in which the synergy contribution of the target is greatest and thus directors' inside information is most valuable to target shareholders), deal protections will receive the greatest deference. In the middle range (where the merger represents mixed consideration or the target is vastly smaller than the survivor), courts will inevitably assess deal-protective terms by evaluating the good faith of the corporate directors who approve these terms, which inevitably will be expressed as a reasonableness type of review.

13.6 Applying *Revlon*

In the years immediately following *Revlon*, one could have been forgiven for supposing that *Revlon* obligated a corporate board to discharge some ill-defined substantive duties once a decision had been made to sell its company. To be sure, there were early cases that held that "there is no single blueprint that a board must follow to fulfill its duties."[43] But there were also unexpected decisions, such as the *QVC* case discussed earlier in this chapter, which demonstrated that courts might undertake searching review under the auspices of the *Revlon* doctrine. And there were also cross-cutting distinctions that had not yet been fully explored, the most important of which was that between fact patterns in which there was a bidding contest with competing suitors and those in which a company's board had decided to sell the firm, or at least to remain open to a sale should an attractive opportunity present itself.

Two recent opinions, one from 2009 and the other from 2015, by the Delaware Supreme Court give a flavor of the current approach to judicial review of a *friendly* change-in-control transaction. In this context, what does it mean for a target board to be under *Revlon* duties? How active can we expect courts to be in reviewing the actions of disinterested boards?

NOTE ON LYONDELL CHEMICAL CO. v. RYAN, *970 A.2D 235 (DEL. 2009)*

An abbreviated account of the facts of *Lyondell* goes as follows. Circa 2007, shortly before the financial crisis, specialty chemical companies in the range of $10 billion in market capitalization were anxious to combine with companies in their same circle, so to speak. Lyondell was a member of this exclusive circle, as was a private Luxembourgian company controlled by Blavatnik, a billionaire. At various times, Blavatnik had floated the idea of

43. *Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279 (Del. 1989).

a possible merger of his company and Lyondell with Dan Smith, Lyondell's Chairman and CEO. Smith rejected these advances because the price range proposed was well below Smith's expectations. Then in May 2007, Blavatnik disclosed in a Schedule 13D filing with the SEC that his company had acquired the right to purchase an 8.3 percent block of stock from Lyondell's largest shareholder. Lyondell's board, as well as the entire market, understood this filing for what it conventionally meant; namely, a signal that Blavatnik had a strong interest in buying all of Lyondell. In other words, Lyondell was "in play." Reading the market signals, Lyondell's disinterested board of directors immediately met to discuss what it should do. The board's somewhat unusual decision was to do absolutely nothing and adopt a "wait and see" posture. That is, the board did not take defensive measures, nor did it seek to assess Lyondell's value, either internally via a DCF valuation or externally by shopping the company to other third-party buyers.

Over the next two months, Lyondell remained passive, although it received an LBO offer from Blackstone. But passions were fierce within Lyondell's small circle of chemical companies. Without contacting Lyondell, Blavatnik's wandering eye soon shifted to another specialty chemical company, and this time he went so far as to sign a merger agreement with it. But at the last moment, Blavatnik was jilted at the altar when yet a third chemical company made a topping bid for his latest acquisition target. Shortly thereafter, Blavatnik approached Smith with a cash offer to acquire Lyondell. Smith succeeded in pressing Blavatnik to raise his initial offer price from $40/share to $48/share, albeit with a large break-up fee if Lyondell got cold feet. And, after a week of valuations by Lyondell's financial advisors and several (seemingly short) board meetings, Blavatnik and Lyondell's board signed a cash merger agreement which was subsequently approved by a 99 percent majority of Lyondell's shareholders.

Of course, the transaction was challenged by a shareholder class action against Lyondell's disinterested outside directors who had signed off on the deal. On a motion to dismiss at summary judgment, the Delaware Chancery court opined that it could not conclude that Lyondell's independent directors had not failed to discharge their *Revlon* duties without a trial.

The Chancery Court opinion emphasized that these directors had indulged in "two months of slothful indifference despite knowing that the company was 'in play' after Blavatnik filed his Schedule 13D. Moreover, the week between Blavatnik's formal offer and the board's assent left little time for adequate discussion of the offer, and the board had failed "to seriously press" Blavatnik for a higher price (although Smith had done so prior to the board's consideration of the offer).

On interlocutory appeal, the Delaware Supreme Court en banc reversed and granted summary judgment in favor of Lyondell's directors. The paragraphs excerpted below from Justice Berger's opinion for the court capture the gist of the decision:

. . . As the trial court correctly noted, *Revlon* did not create any new fiduciary duties. It simply held that the "board must perform its fiduciary duties in the service of a specific objective: maximizing the sale price of the enterprise." The trial court reviewed the record, and found that Ryan [the shareholder- plaintiff] might be able to prevail at trial on a claim that the Lyondell directors breached their duty of care. But Lyondell's charter includes an exculpatory provision, pursuant to 8 Del. C. §102(b)(7), protecting the directors from personal liability for breaches of the duty of care. Thus, this case turns on whether any arguable short comings on the part of the Lyondell directors also implicate their duty of loyalty, a breach of which is not exculpated. Because the trial court determined that the board was independent and was not motivated by self-interest or ill will, the sole issue is whether the directors are entitled to summary judgment on the claim that they breached their duty of loyalty by failing to act in good faith.

* * *

Directors' decisions [when *Revlon* duties are triggered] must be reasonable, not perfect. "In the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties." The trial court denied summary judgment because the Lyondell directors' "un-explained inaction" prevented the court from determining that they had acted in good faith. But, if the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty. The trial court approached the record from the wrong perspective. Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price.

* * *

. . . [T]his record clearly establishes that the Lyondell directors did not breach their duty of loyalty by failing to act in good faith. In concluding otherwise, the Court of Chancery reversibly erred.

NOTE ON C&J ENERGY SERVICES, INC. v. CITY OF MIAMI GENERAL EMPLOYEES AND SANITATION EMPLOYEES RETIREMENT TRUST, *107 A.3D 1049 (DEL. 2014)*

A very recent statement of the Delaware Supreme Court on the freedom of non-conflicted boards in selling the company to adopt whatever tactic they deem appropriate in the good-faith exercise of their business judgment was contained in the en banc reversal of a preliminary injunction issued by a Vice Chancellor enjoining a deal for 30 days and requiring the board to shop the company more actively. The Vice Chancellor, of course, believed he was fulfilling the mandate of the *Revlon* case.

STRINE, C.J., for the Court en banc:

. . .

The proposed transaction is itself unusual in that C&J, a U.S. corporation, will acquire a subsidiary of Nabors [Inc.], which is domiciled in Bermuda, but Nabors will retain a majority of the equity in the surviving company. To obtain more favorable tax rates, the surviving entity, C&J Energy Services, Ltd. ("New C&J"), will be based in Bermuda, and thus subject to lower corporate tax rates than C&J currently pays.

To temper Nabors majority voting control of the surviving company, C&J negotiated for certain protections, including a bye-law [court notes this is spelling used in Bermuda—EDS.] guaranteeing that all stockholders would share pro rata in any future sale of New C&J, which can only be repealed by a unanimous stockholder vote. [Compare *QVC* and *Delphi Financial* cases above—EDS.] C&J also bargained for a "fiduciary out" if a superior proposal was to emerge during a lengthy passive market check. . . . And during that market check, a potential competing bidder faced only modest deal protection barriers.

Although the Court of Chancery found that the C&J board harbored no conflict of interest and was fully informed about its own company's value, the court determined there was a "plausible" violation of the board's *Revlon* duties because the board did not affirmatively shop the company either before or after signing. On that basis, the Court of Chancery enjoined the stockholder vote for 30 days, despite finding no reason to believe that C&J stockholders — who must vote to approve the transaction — would not have a fair opportunity to evaluate the deal for themselves on its economic merits.

The Court of Chancery's order also required C&J to shop itself in violation of the merger agreement between C&J and Nabors, which prohibited C&J from soliciting other bids. The order dealt with this issue by stating "[t]he solicitation of proposals consistent with this Order and any subsequent negotiations of any alternative proposal that emerges will not constitute a breach of the Merger Agreement in any respect."

But the Court of Chancery did not rely on undisputed facts showing a reasonable probability that the board had breached its fiduciary duties when it imposed this mandatory, affirmative injunction. Instead, it is undisputed that a deal with Nabors made strategic business sense and offered substantial benefits for C&J's stockholders. Moreover, the order stripped Nabors of its contractual rights even though the Court of Chancery did not make any finding that Nabors was an aider and abettor, . . . finding that there was a reasonable probability of a breach by C&J's board that Nabors could have aided and abetted.

We assume for the sake of analysis that *Revlon* was invoked by the pending transaction because Nabors will acquire a majority of New C&J's

voting shares. But we nonetheless conclude that the Court of Chancery's injunction cannot stand. A preliminary injunction must be supported by a finding by the Court of Chancery that the plaintiffs have demonstrated a reasonable probability of success on the merits. The Court of Chancery made no such finding here, and the analysis that it conducted rested on the erroneous proposition that a company selling itself in a change of control transaction is required to shop itself to fulfill its duty to seek the highest immediate value. But *Revlon* and its progeny do not set out a specific route that a board must follow when fulfilling its fiduciary duties, and an independent board is entitled to use its business judgment to decide to enter into a strategic transaction that promises great benefit, even when it creates certain risks. When a board exercises its judgment in good faith, tests the transaction through a viable passive market check, and gives its stockholders a fully informed, uncoerced opportunity to vote to accept the deal, we cannot conclude that the board likely violated its *Revlon* duties. It is too often forgotten that *Revlon*, and later cases like *QVC*, primarily involved board resistance to a competing bid after the board had agreed to a change of control, which threatened to impede the emergence of another higher-priced deal. No hint of such a defensive, entrenching motive emerges from this record. . . .

QUESTIONS AND NOTES

1. There has never been an injunction issued in a *Revlon* case and sustained on appeal where there was not an ongoing bidding contest. Courts are understandably reluctant to enjoin a premium deal for target shareholders because of defects in the target company's sale process when no other premium transaction is at hand. A less than fair premium price is better than no premium at all.

2. Despite the preceding observation, however, *Lyondell* demonstrates why it is difficult to recover damages in a *Revlon* action when board members are independent. Section 102(b)(7) precludes seeking monetary damages from directors unless they act in bad faith, which is extremely difficult to prove.

3. *Lyondell* might lead one to think that we are back to the old-time religion that arm's length mergers are only subject to business judgment review. But this is not entirely the case for transactional lawyers. A lawyer working on negotiating or drafting a friendly acquisition agreement cannot know for certain whether it will meet a shareholder challenge. An alternative deal might come out of the woodworks and challenge the provisions of the agreement that have a defensive effect. Thus, she must draft on the assumption that her work might be closely reviewed.

13.7 Regulation of Takeovers in Other Legal Systems

The multiple forces that produced the phenomenon of hostile takeovers in the United States — including changes in technology, financial markets, and

In some aspects, an appraisal action is the easier form of action for shareholders, since the plaintiff need only establish that they properly dissented from the transaction to seek appraisal and need not show that the board or a controlling shareholder breached a fiduciary duty. In most other respects, however, an action alleging breach of entire fairness seems more favorable to plaintiffs. Under the statutory standard, a plaintiff in an appraisal proceeding is entitled to claim only a pro rata share of the fair value of the company *without regard to any gain caused by the merger or its expectation.* By contrast, in a fiduciary "fairness" action against a controlling shareholder, the defendant must prove that a self-dealing transaction was fair in all respects. See *Weinberger v. UOP Inc.*, discussed above in Chapter 8. If the defendant fails in this, the possible remedies are very broad and may include rescission or "rescissory damages." (Rescissory damages are the financial equivalent to what rescission would bring, were it feasible.) Perhaps even more advantageous, at least for plaintiffs' lawyers, fairness claims can be brought as class actions in the name of all minority shareholders — not just those relatively few who will have bothered to dissent. Put differently, the class action procedure gives to plaintiffs and their lawyers the great leverage that results from a large "opt-out" class of shares.

In Section 12.8, we discuss the fascinating development of judicial review of controlled mergers. As you read it over, ask yourself: How do appraisal proceedings and suits for breach of fiduciary duty compare now given recent developments in both areas?

12.8 The Duty of Loyalty in Controlled Mergers

As we discussed in Chapter 8, U.S. corporate law generally provides that controlling shareholders owe to the corporation and its minority shareholders a fiduciary duty of loyalty whenever they exercise any aspect of their control over corporate actions and decisions.[71] All shareholders, however, have the right to vote their shares in their own best interests.[72] Thus, there is some tension between a controlling shareholder's exercise of voting rights, which can arguably reflect her own "selfish" self-interest, and her exercise of "control" over the corporation or its property, which cannot. What precisely is the exercise of control that gives rise to an obligation of fairness? It is best defined as the de facto power to do what other shareholders cannot, such as the controller's power

71. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717. (Del. 1971) (*Sinclair Oil* is the source of a particular test for invoking the entire fairness burden: that the corporate transaction under scrutiny treats the controller differently than the other shareholders before the obligation to prove its fairness arises. Of course, this test is typically met in freeze-out mergers).

72. *Tanzer v. International General Industries, Inc.*, 379 A.2d 1221 (Del. 1977).

to access non-public corporate information or influence the board to approve a transaction (e.g., a merger) with another company in which the controller is financially interested.

Controlled mergers, including parent-subsidiary mergers, expose minority shareholders to an acute risk of exploitation. Today, we describe most of these mergers as "cash-out," "freeze-out," or "going-private" mergers. But a merger is not the only technique for accomplishing a cash-out or freeze-out. Asset sales and reverse stock splits can also be freeze-out techniques. For example, a controlling shareholder can cause the company to sell all of its assets to his wholly owned firm, in exchange for cash, which may then be distributed to the company's shareholders in liquidation. Alternatively, a controlling shareholder can cause the company to radically decrease its number of shares and pay off minority shareholders in cash for fractional shares. If the reverse split is dramatic enough, only one shareholder will be left after it is completed.[73]

12.8.1 Cash Mergers or Freeze-Outs

Nineteenth-century corporation lawyers would have been horrified (or maybe delighted) by the cash-out merger. Even after the repudiation of the unanimity rule allowed a qualified majority of shareholders to impose a merger against the will of a disagreeing minority, all shareholders had the right to continue as shareholders of the surviving entity. Indeed, this is still the rule in most non-U.S. jurisdictions that recognize mergers.

Nevertheless, by the 1920s, the idea of cashing out minority shareholders through the merger device no longer shocked the consciences of U.S. corporate lawyers. Florida led the way by amending its statute in 1925 to permit cash consideration in a merger. Other states followed. Delaware

73. To better understand a reverse stock split, first consider a normal stock split. In a normal stock split, either the company pays a stock dividend on its outstanding shares, so that each shareholder receives more stock for each share already held, or the company amends its charter to provide that each share is "reclassified" into more than one share. Of course, the company's expected cash flows and earnings are unaffected by simply changing the number of shares outstanding, and the only other certain result of a split is to reduce the company's stock price in proportion (or nearly so) to the split. Typical stock splits are 2-for-1 or 3-for-1 and are used to decrease the per-share price to a "normal" range ($10 to $200). Lower absolute stock prices reduce an investor's threshold investment: Stock is generally traded in round lots of 100 shares, and purchases of smaller ("odd") lots usually involve higher transaction costs. Well-timed splits may thus have the real economic effect of increasing the liquidity of a stock and so may (modestly) increase the total value of outstanding shares.

In a reverse stock split, the opposite effect is achieved. A controlling shareholder amends the corporate charter to provide for the combination of some large number of shares into a single share (e.g., 1-for-10, 1-for-100, etc.). Cash is provided to shareholders holding less than a single share ("fractional share") after the reverse split, pursuant to statute. See DGCL §155. The reverse split ratio is set large enough to ensure that only the controlling shareholder ends up with one or more whole shares of stock; all other shareholders end up with fractional shares (and thus cash).

was customarily cautious; it did not authorize the use of cash in short-form mergers until 1957 and not in long-form mergers until 1967. The MBCA followed in 1968 and 1969, respectively.[74] Cash-out mergers (or freeze-outs) emerged as a controversial topic during the 1960s and 1970s, when a period of low stock market prices followed after a boom in public offerings of stock. The low stock values allowed many controlling shareholders to cash out public shareholders at prices substantially below the prices that these investors had paid for the same shares a short time before. This raised complaints about unfairness. Critics argued, among other things, that such transactions often occurred when the pro rata asset value of these firms greatly exceeded the market price of their publicly traded shares. It was widely thought that, in these circumstances, a "cash-out" even at a premium price allowed controlling shareholders to capture a disproportionate share of the company's value.[75]

At the federal level, the SEC adopted Rule 13e-3 under the Williams Act, which requires a great deal of specified disclosure whenever a controller seeks to tender for the minority shares of its company. See Statutory Supplement. At the state level, courts in Delaware and elsewhere wrestled with the task of protecting minority shareholders without banning freeze-outs altogether. At first, in *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977), the Delaware courts announced that going private transactions would henceforth constitute a breach of duty by a controlling shareholder unless the controller could demonstrate a valid business purpose for the transaction. This rule, however, proved unstable. By 1985, it was replaced by the Delaware Supreme Court's analysis in the *Weinberger* opinion, which we discussed in Chapter 8.

Weinberger thus established the modern articulation of the rule governing controlling-shareholder related-party transactions. Once a plaintiff alleges a freeze out transaction between a controller and a company, the fiduciary controller will be deemed to have the burden of establishing that the transaction is fair in all respects: that is, that the process of the deal and the terms of the deal are entirely fair to the corporation and its minority shareholders.

74. See generally Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. Rev. 624, 632 (1981); Arthur M. Borden, *Going Private — Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. Rev. 987 (1974).

75. For example, in a much-publicized speech given at the University of Notre Dame in November 1974, SEC Commissioner A.A. Sommer said:

> Daily we read of companies which are offering to buy out all, or substantially all, of their shareholders, thus enhancing the control of the controlling shareholders and freeing the corporation of the "burdens" of being publicly-held. In other instances clever and indeed most imaginative devices are used to afford the small shareholders little, if any, choice in the matter. What is happening is, in my estimation, serious, unfair, and sometimes disgraceful, a perversion of the whole process of public financing, and a course that inevitably is going to make the individual shareholder even more hostile to American corporate mores and the securities markets than he already is.

A.A. Sommer, Jr., Law Advisory Council Lecture, Notre Dame Law School (Nov. 1974) in [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) 80,010, at 84,695 (Nov. 20, 1974).

The *Weinberger* case left in its wake important undecided issues beyond the central question of just what constituted fair process and fair price in a parent-subsidiary merger. One of these was the hallmarks of "control" that trigger the deployment of the entire fairness standard. Another was the legal effect of interposing an independent negotiating committee between a board and a controlling shareholder. A third was the relationship between a majority-of-the-minority (MOM) shareholder vote of approval and a deal price negotiated by an independent board committee fully empowered to accept or reject a controller's proposed deal.[76] Finally, a last subsidiary issue was whether the entire fairness standard would apply to a two-step freeze-out transaction in which a controller employed a tender offer to obtain 90 percent of outstanding shares and then resorted to DGCL §253 to cash out the remaining minority shareholders. We consider the history of these issues in this section.

Weinberger's forceful suggestion that it might be a good idea in freeze-out transactions to empanel a committee of independent directors to negotiate with the controller at arm's length gave rise to a practice in freeze-out transactions to do just that. In that evolving practice, boards would appoint a committee of independent board members who would, with the help of independent bankers and lawyer advisors, negotiate the deal, presumably saying no to any deal that did not offer both a fair price and the best price available from the controller. The hope of deal planners was that when such transactions were attacked in court as unfair to public shareholders, the courts would accord, some kind of deference to the judgment of the independent committees.

Early on (1988), the Court of Chancery indicated a willingness to review freeze-out mergers under the business judgment rule, if a board committee of independent directors was comprised of truly independent directors and the process otherwise had integrity. (See *In re Trans World Airlines Shareholders Litig.*, CIV. A. No. 9844, 1988 WL 111271 (Del. Ch. Oct. 21, 1988).) but other Chancery opinions of the period held otherwise. This split in authority was not resolved by the Delaware Supreme Court until its 1994 opinion in *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (1994).

KAHN v. LYNCH COMMUNICATION SYSTEMS, INC.
638 A.2d 1110 (Del. 1994)

[Alcatel U.S.A. Corporation (Alcatel), a holding company, is an indirect subsidiary of Compagnie Generale d'Electricite (CGE), a French corporation. In 1981, Alcatel acquired 30.6 percent of the common stock of

76. *Weinberger* noted that a majority of the minority shareholder vote in favor of the freeze-out would shift the burden of proof on entire fairness to the plaintiff and soon the courts held a favorable vote by an informed independent committee did too. This of course made the majority of the minority shareholder vote appear superfluous. See Guhan Subramanian, *Fixing Freezeouts*, 115 Yale L.J. 2 (2005).

Lynch Communication Systems, Inc. (Lynch) pursuant to a stock purchase agreement.]

HOLLAND, J.:

By the time of the merger which is contested in this action, Alcatel owned 43.3 percent of Lynch's outstanding stock; designated five of the eleven members of Lynch's board of directors; two of three members of the executive committee; and two of four members of the compensation committee.

In the spring of 1986, Lynch determined that in order to remain competitive in the rapidly changing telecommunications field, it would need to obtain fiber optics technology to complement its existing digital electronic capabilities. Lynch's management identified a target company, Telco Systems, Inc. ("Telco"), which possessed both fiber optics and other valuable technological assets. The record reflects that Telco expressed interest in being acquired by Lynch. Because of the supermajority voting provision, which Alcatel had negotiated when it first purchased its shares, in order to proceed with the Telco combination Lynch needed Alcatel's consent. In June 1986, Ellsworth F. Dertinger ("Dertinger"), Lynch's CEO and chairman of its board of directors, contacted Pierre Suard ("Suard"), the chairman of Alcatel's parent company, CGE, regarding the acquisition of Telco by Lynch. Suard expressed Alcatel's opposition to Lynch's acquisition of Telco. Instead, Alcatel proposed a combination of Lynch and Celwave Systems, Inc. ("Celwave"), an indirect subsidiary of CGE engaged in the manufacture and sale of telephone wire, cable and other related products.

Alcatel's proposed combination with Celwave was presented to the Lynch board at a regular meeting held on August 1, 1986. Although several directors expressed interest in the original combination which had been proposed with Telco, the Alcatel representatives on Lynch's board made it clear that such a combination would not be considered before a Lynch/Celwave combination. According to the minutes of the August 1 meeting, Dertinger expressed his opinion that Celwave would not be of interest to Lynch if Celwave was not owned by Alcatel.

At the conclusion of the meeting, the Lynch board unanimously adopted a resolution establishing an Independent Committee, consisting of Hubert L. Kertz ("Kertz"), Paul B. Wineman ("Wineman"), and Stuart M. Beringer ("Beringer"), to negotiate with Celwave and to make recommendations concerning the appropriate terms and conditions of a combination with Celwave. On October 24, 1986, Alcatel's investment banking firm, Dillon, Read & Co., Inc. ("Dillon Read") made a presentation to the Independent Committee. Dillon Read expressed its views concerning the benefits of a Celwave/Lynch combination and submitted a written proposal of an exchange ratio of 0.95 shares of Celwave per Lynch share in a stock-for-stock merger.

However, the Independent Committee's investment advisors, Thomson McKinnon Securities Inc. ("Thomson McKinnon") and Kidder, Peabody & Co. Inc. ("Kidder Peabody"), reviewed the Dillon Read proposal and concluded that the 0.95 ratio was predicated on Dillon Read's overvaluation of Celwave.

Based upon this advice, the Independent Committee determined that the exchange ratio proposed by Dillon Read was unattractive to Lynch. The Independent Committee expressed its unanimous opposition to the Celwave/Lynch merger on October 31, 1986.

Alcatel responded to the Independent Committee's action on November 4, 1986, by withdrawing the Celwave proposal. Alcatel made a simultaneous offer to acquire the entire equity interest in Lynch, constituting the approximately 57 percent of Lynch shares not owned by Alcatel. The offering price was $14 cash per share.

On November 7, 1986, the Lynch board of directors revised the mandate of the Independent Committee. It authorized Kertz, Wineman, and Beringer to negotiate the cash merger offer with Alcatel. At a meeting held that same day, the Independent Committee determined that the $14 per share offer was inadequate. The Independent's Committee's own legal counsel, Skadden, Arps, Slate, Meagher & Flom ("Skadden Arps"), suggested that the Independent Committee should review alternatives to a cash-out merger with Alcatel, including a "white knight" third party acquirer, a repurchase of Alcatel's shares, or the adoption of a shareholder rights plan.

On November 12, 1986, Beringer, as chairman of the Independent Committee, contacted Michiel C. McCarty ("McCarty") of Dillon Read, Alcatel's representative in the negotiations, with a counteroffer at a price of $17 per share. McCarty responded on behalf of Alcatel with an offer of $15 per share. When Beringer informed McCarty of the Independent Committee's view that $15 was also insufficient, Alcatel raised its offer to $15.25 per share. The Independent Committee also rejected this offer. Alcatel then made its final offer of $15.50 per share.

At the November 24, 1986 meeting of the Independent Committee, Beringer advised its other two members that Alcatel was "ready to proceed with an unfriendly tender at a lower price" if the $15.50 per share price was not recommended by the Independent Committee and approved by the Lynch board of directors. Beringer also told the other members of the Independent Committee that the alternatives to a cash-out merger had been investigated but were impracticable. After meeting with its financial and legal advisors, the Independent Committee voted unanimously to recommend that the Lynch board of directors approve Alcatel's $15.50 cash per share price for a merger with Alcatel. The Lynch board met later that day. With Alcatel's nominees abstaining, it approved the merger. . . .

Alcatel held a 43.3 percent minority share of stock in Lynch. Therefore, the threshold question to be answered by the Court of Chancery was whether, despite its minority ownership, Alcatel exercised control over Lynch's business affairs. Based upon the testimony and the minutes of the August 1, 1986 Lynch board meeting, the Court of Chancery concluded that Alcatel did exercise control over Lynch's business decisions.

At the August 1 meeting, Alcatel opposed the renewal of compensation contracts for Lynch's top five managers. According to Dertinger, Christian Fayard ("Fayard"), an Alcatel director, told the board members, "you must listen to us. We are 43 percent owner. You have to do what we tell you."

Although Beringer and Kertz, two of the independent directors, favored renewal of the contracts, according to the minutes, the third independent director, Wineman, admonished the board as follows:

> Mr. Wineman pointed out that the vote on the contracts is a "watershed vote" and the motion, due to Alcatel's "strong feelings," might not carry if taken now. Mr. Wineman clarified that "you [management] might win the battle and lose the war." With Alcatel's opinion so clear, Mr. Wineman questioned "if management wants the contracts renewed under these circumstances." He recommended that management "think twice." Mr. Wineman declared: "I want to keep the management. I can't think of a better management." Mr. Kertz agreed, again advising consideration of the "critical" period the company is entering.

The minutes reflect that the management directors left the room after this statement. The remaining board members then voted not to renew the contracts.

At the same meeting, Alcatel vetoed Lynch's acquisition of the target company, which, according to the minutes, Beringer considered "an immediate fit" for Lynch. Dertinger agreed with Beringer, stating that the "target company is extremely important as they have the products that Lynch needs now." Nonetheless, Alcatel prevailed. The minutes reflect that Fayard advised the board: "Alcatel, with its 44% equity position, would not approve such an acquisition as it does not wish to be diluted from being the main shareholder in Lynch." From the foregoing evidence, the Vice Chancellor concluded:

> . . . Alcatel did control the Lynch board, at least with respect to the matters under consideration at its August 1, 1986 board meeting. . . .

The record supports the Court of Chancery's underlying factual finding that "the non-Alcatel [independent] directors deferred to Alcatel because of its position as a significant stockholder and not because they decided in the exercise of their own business judgment that Alcatel's position was correct." The record also supports the subsequent factual finding that, notwithstanding its 43.3 percent minority shareholder interest, Alcatel did exercise actual control over Lynch by dominating its corporate affairs. . . .

A controlling or dominating shareholder standing on both sides of a transaction, as in a parent-subsidiary context, bears the burden of proving its entire fairness. . . .

The logical question raised by this Court's holding in *Weinberger* was what type of evidence would be reliable to demonstrate entire fairness. That question was not only anticipated but also initially addressed in the *Weinberger* opinion. *Id.* at 709-10 n.7. This Court suggested that the result "could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length," because "fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors." *Id.* Accordingly, this Court stated, "a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong *evidence* that the transaction meets the test of fairness." *Id.* (emphasis added).

. . . In *Weinberger*, this Court recognized that it would be inconsistent with its holding [to abolish the business purpose requirement] to apply the business judgment rule in the context of an interested merger transaction which, by its very nature, did not require a business purpose. Consequently, [an informal vote by a majority of the minority shareholders merely shifts the burden of proof as to proving unfairness. — EDS.] . . .

Even where no coercion is intended, [minority] shareholders voting on a parent subsidiary merger might perceive that their disapproval could risk retaliation of some kind by the controlling stockholder. For example, the controlling stockholder might decide to stop dividend payments or to effect a subsequent cash out merger at a less favorable price, for which the remedy would be time consuming and costly litigation. At the very least, the potential for that perception, and its possible impact upon a shareholder vote, could never be fully eliminated. . . .

Once again, this Court holds that the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness. . . . The initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction. . . . However, an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff. . . .

[However, t]he mere existence of an independent special committee does not itself shift the burden. At least two factors are required. First, the majority shareholder must not dictate the terms of the merger. . . . Second, the special committee must have real bargaining power that it can exercise with the majority shareholder on an arm's length basis. . . .

[T]he performance of the Independent Committee merits careful judicial scrutiny to determine whether Alcatel's demonstrated pattern of domination was effectively neutralized. . . . The fact that the same independent directors had submitted to Alcatel's demands on August 1, 1986 was part of the basis for the Court of Chancery's finding of Alcatel's domination of Lynch. Therefore, the Independent Committee's ability to bargain at arm's length with Alcatel was suspect from the outset.

The Independent Committee's second assignment was to consider Alcatel's proposal to purchase Lynch. The Independent Committee proceeded on that task with full knowledge of Alcatel's demonstrated pattern of domination. The Independent Committee was also obviously aware of Alcatel's refusal to negotiate with it on the Celwave matter.

The Court of Chancery gave credence to the testimony of Kertz, one of the members of the Independent Committee, to the effect that he did not believe that $15.50 was a fair price but that he voted in favor of the merger because he felt there was no alternative.

The Court of Chancery also found that Kertz understood Alcatel's position to be that it was ready to proceed with an unfriendly tender offer at a lower price if Lynch did not accept the $15.50 offer, and that Kertz perceived this to be a threat by Alcatel. . . .

According to the Court of Chancery, the Independent Committee rejected three lower offers for Lynch from Alcatel and then accepted the $15.50 offer "after being advised that [it] was fair and after considering the absence of alternatives." . . .

Nevertheless, based upon the record before it, the Court of Chancery found that the Independent Committee had "appropriately simulated a third-party transaction, where negotiations are conducted at arm's length and there is no compulsion to reach an agreement." . . .

The Court of Chancery's determination . . . is not supported by the record. . . . [T]he ability of the Committee effectively to negotiate at arm's length was compromised by Alcatel's threats to proceed with a hostile tender offer if the $15.50 price was not approved by the Committee and the Lynch board. The fact that the Independent Committee rejected three initial offers, which were well below the Independent Committee's estimated valuation for Lynch and were not combined with an explicit threat that Alcatel was "ready to proceed" with a hostile bid, cannot alter the conclusion that any semblance of arm's length bargaining ended when the Independent Committee surrendered to the ultimatum that accompanied Alcatel's final offer.

Accordingly, the judgment of the Court of Chancery is reversed. This matter is remanded for further proceedings consistent herewith, including a redetermination of the entire fairness of the cash-out merger to Kahn and the other Lynch minority shareholders with the burden of proof remaining on Alcatel, the dominant and interested shareholder.

QUESTION ON KAHN v. LYNCH COMMUNICATION SYSTEMS

Did the court correctly decide that Alcatel breached its duty of fair dealing with the corporation and its public shareholders? Why can't Alcatel be a tough bargainer? If Alcatel had simply extended a tender offer at the price it was interested in paying, would it have breached its duty?

NOTE ON LIABILITY OF INDEPENDENT DIRECTORS IN CONTROLLER BUYOUT TRANSACTIONS

Weinberger reiterated that a controller owes a duty of entire fairness to minority shareholders when it engineers a cash-out or freeze-out transaction. It also suggested that a controller can enhance the fairness of such a transaction by agreeing to negotiate with a committee of the company's independent directors that is charged with representing the interests of the company and its minority shareholders. The rationale, of course, is that a simulation of arms length bargaining should go part of the way toward providing the protections that one naturally expects in arms length bargaining between a target company and a third-party acquirer. But neither *Weinberger* nor *Kahn v. Lynch* address the question of what liability rules apply to those directors who serve on a committee charged with negotiating with a controlling shareholder.

The members of such an independent committee are in a tough spot if they believe that the controller will stand firm on an unfairly low price. If the controller's proposed deal price offers a premium to minority shareholders relative to the pre-offer market price — but still below the fair value of minority shares — they might agree to the controller's price out of fear that the controller will otherwise pull its offer entirely. Before or after the deal closes, shareholders might allege that the recommendation of the independent committee was "coerced" and that the committee itself was dominated by the controller. The defendants in such an action would include the controller, of course, but they would also include the directors on the independent committee. Since these directors were free of conflicts and presumably recommended the controller's offer in good faith, the only plausible liability theory is a duty of care claim, i.e., gross negligence, recklessness, etc. Since virtually all U.S. public corporations now include an "exculpatory clause" under DGCL §102(b)(7) in their charters, it might seem that claims against independent directors should be dismissed even if the complaint against the controlling shareholder survives a motion to dismiss.

This is, in fact, the law today. But the evolution of doctrine has not always been linear. Two Delaware Supreme Court decisions in 2001 addressed this issue in different contexts. In *Malpiede v. Townson*,[77] the court held that in an acquisition not involving a controlling shareholder a §102(b)(7) waiver would lead to pretrial dismissal of suit against outside directors absent claims of duty of loyalty breaches. On the other hand, the court in *Emerald Partners v. Berlin*,[78] held that in the freeze-out context, where entire fairness is the standard of judicial review, a charter waiver of damages under §102(b)(7) could not be the basis of a pretrial dismissal of suits against outside directors.[79] Given that the typical claim in a freeze-out is that the controller violated the duty of loyalty one might understandably be uncomfortable with dismissing claims against directors appointed by that controller. Nonetheless, this led to the somewhat unsatisfying outcome that pretrial dismissal of suits against outside directors depended on whether the challenged deal was a freeze-out rather than on whether the plaintiff plead a non-exculpable violation. This remained the law until 2015, when another Supreme Court decision,

77. 780 A.2d 1075 (Del. 2001).
78. 787 A.2d 85 (Del. 2001).
79. The court stated "when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only after the basis for their liability has been decided [at trial or on summary judgment]." 787 A.2d at 94.

In re Cornerstone Therapeutics Inc Shareholder Litigation,[80] held that even though a controlled going-private transaction was subject to entire fairness review, the company's §102(b)(7) waiver in its charter would require independent directors to remain in the litigation only if plaintiffs could plausibly plead their non-exculpated violation of the duty of loyalty.

12.8.2 The "Proceduralization" of Going-Private Transactions

Until roughly 2000, almost all freeze-out transactions of Delaware corporations took the form of one-step cash-out mergers and faced the prospect of entire fairness judicial review. These were, after all, extreme related-party transactions that eliminated minority shareholder interests entirely. After *Weinberger*, the most that controllers could do to insulate freeze-outs from challenges by minority shareholders was to condition their deals on negotiated outcomes with committees of independent directors or on the outcomes of MOM shareholder votes. However, an influential case in 2001, *In re Siliconix Incorporated Shareholder Litigation*, C.A. No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001),[81] held that controlling shareholder tender offers to minority shareholders were not subject to entire fairness review (because they are direct offers to shareholders without relying on the board or other corporate organ to approve). Enterprising deal lawyers soon used this holding to fashion a novel transactional model for going-private transactions. A controller might first make a tender offer for minority shares and subsequently cash out the remaining minority shareholders at the tender offer price. This was not novel in a fundamental conceptual way. After all, the Timber Jack transaction described earlier in this chapter shows that two-step acquisitions had already been a common deal practice for decades. Rather, the novelty lay in the way that the two-step templet cabined the risk of unfavorable judicial review. The controller's first-step tender offer did not face entire fairness review. As for the second-step merger, a strong shareholder response to the price offered in the first step tended to suggest that the price was likely to be viewed as fair. Still more important, a controller who held more than 90 percent of her company's shares after a first-step tender offer could execute the second step as a short-form merger under DGCL §253. A contemporaneous Chancery Court decision had held that §253 short-form mergers were not subject to entire fairness review.[82] Thus, the bottom line during this period was that there were two templets for going-private transactions. Under the one-tier, so-called "*Lynch*" templet, entire fairness review was unavoidable, while under the two-tier "*Siliconix*" templet, a cash-out of minority shareholders might proceed with little more than business judgment review.

80. 115 A. 3d 1173 (Del. 2015).
81. See also *Solomon v. Pathe Communications Corp.*, 672 A.2d 35 (Del. 1996).
82. *In re Unocal Exploration Corporation*, 793 A.2d 329 (Del. Ch. 2000). Its holding is more accurately described as precluding any remedy other than appraisal in DGCL §253 mergers.

These data raise policy questions. . . .

Solomon II, *Siliconix*, and *Pure Resources* rely primarily on market forces, impose few procedural protections, and limit judicial review. All else equal, this approach should lead to more transactions and lower premiums. *Lynch* de-emphasizes market forces, encourages procedural protections, and relies heavily on judicial review. All else equal, this approach should lead to fewer transactions and higher premiums. Prominent commentators have suggested that *Siliconix* and *Pure Resources* may be too lenient towards controllers and under-protective of minority stockholders, while *Lynch* may be too strict and overprotective. They recommend a regime that applies the business judgment rule to a transaction that mimics third party transactional approvals, while allowing controllers the flexibility to employ fewer protections at the cost of some level of fairness review. . . . Only the Supreme Court can determine definitively whether different policies, duties, and standards should govern unilateral two-step freeze-outs.

Because the appropriate standard of review for unilateral two-step freeze-out presents a question of first impression for the Delaware Supreme Court and implicates fundamental issues of Delaware public policy, certification is appropriate.

In re CNX Gas Corp., C.A. No. 5377-VCL, 2010 WL 2705147 at *11-*12 (Del. Ch. July 5, 2010).

The Delaware Supreme Court denied the appeal on the grounds that the issues raised in the case should be addressed after the entry of a final judgment. *In re CNX Gas Corp.*, 30 A. 3d 782 (Del. 2010).

12.8.3 The Other Shoe Drops: One-Step Freeze-Out Mergers

In re CNX Gas Corp. seemed to give a clear roadmap to business judgment review for two-step freeze-out transactions, even though the the Delaware Supreme Court's reluctance to grant an interlocutory appeal on the matter might also be seen to suggest continuing uneasiness about the procedural makeover that *CNX* implied. Another matter to consider was that *CNX* did not resolve the doctrinal incongruity that controllers could obtain business judgment review in a two-step freeze-out but not the one-step freeze-out merger. The then Chancellor, Leo Strine, who earlier had been the first judge to float a proposal to allow business judgment review in freeze-out mergers, was also the first judge to rule that business judgment review was available to controllers in a one-step freeze-out merger. See *In re MFW Shareholders Litig.*, 67 A.3d 496 (Del. Ch. 2013). The Delaware Supreme Court heard this case on appeal shortly after Strine had been appointed to be Chief Justice of the Supreme Court. The opinion below reflects that Court's en banc decision to affirm the Chancery Court's decision below. Our reading of this opinion also reflects a note of hesitation, although there is no doubt that the road to business judgment review that the opinion affirms is now firmly established Delaware law.

KAHN v. M&F WORLDWIDE CORP. ET AL.

88 A.3d 635 (Del. 2014)

HOLLAND, J. for the Court *en banc*:

This is an appeal from a final judgment entered by the Court of Chancery in a proceeding that arises from a 2011 acquisition by MacAndrews & Forbes Holdings, Inc. ("M & F" or "MacAndrews & Forbes") — a 43% stockholder in M & F Worldwide Corp. ("MFW") — of the remaining common stock of MFW (the "Merger") [at a price of $25 per share]. From the outset, M & F's proposal to take MFW private was made contingent upon two stockholder-protective procedural conditions. First, M & F required the Merger to be negotiated and approved by a special committee of independent MFW directors (the "Special Committee"). Second, M & F required that the Merger be approved by a majority of stockholders unaffiliated with M & F. The Merger closed in December 2011, after it was approved by a vote of 65.4% of MFW's minority stockholders.

[After expedited discovery, shareholder-plaintiffs' withdrew a motion for a preliminary injunction and after following further discovery, defendants moved for summary judgment, which was granted.]

COURT OF CHANCERY DECISION

The Court of Chancery found that the case presented a "novel question of law"; specifically, "what standard of review should apply to a going private merger conditioned upfront by the controlling stockholder on approval by both a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority vote." . . .

The Court of Chancery held that, rather than entire fairness, the business judgment standard of review should apply "if, but only if: (i) the controller conditions the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee acts with care; (v) the minority vote is informed; and (vi) there is no coercion of the minority."

[It] found that those prerequisites were satisfied and that the Appellants had failed to raise any genuine issue of material fact indicating the contrary. The court then reviewed the Merger under the business judgment standard and granted summary judgment for the Defendants.

APPELLANTS' ARGUMENTS

The Appellants raise two main arguments on this appeal. First, they contend that the Court of Chancery erred in concluding that no material disputed facts existed regarding the conditions precedent to business judgment review. The Appellants submit that the record contains evidence showing that the Special Committee was not disinterested and independent, was not fully empowered, and was not effective. [Notice that the Court of Chancery did not include "effective" as a prerequisite for application of BJR. — EDS.] . . .

Second, the Appellants submit that the Court of Chancery erred, as a matter of law, in holding that the business judgment standard applies to controller freeze-out mergers where the controller's proposal is conditioned on both Special Committee approval and a favorable majority-of-the-minority vote. Even if both procedural protections are adopted, the Appellants argue, entire fairness should be retained as the applicable standard of review.

. . .

FACTS

MFW is a holding company incorporated in Delaware. Before the Merger . . . MFW was 43.4% owned by MacAndrews & Forbes, which in turn is entirely owned by Ronald O. Perelman. MFW had four business segments. Three were owned through a holding company, Harland Clarke Holding Corporation ("HCHC"). . . .

The MFW board had thirteen members. They were: Ronald Perelman, Barry Schwartz, William Bevins, Bruce Slovin, Charles Dawson, Stephen Taub, John Keane, Theo Folz, Philip Beekman, Martha Byorum, Viet Dinh, Paul Meister, and Carl Webb. Perelman, Schwartz, and Bevins were officers of both MFW and MacAndrews & Forbes. Perelman was the Chairman of MFW and the Chairman and CEO of MacAndrews & Forbes; Schwartz was the President and CEO of MFW and the Vice Chairman and Chief Administrative Officer of MacAndrews & Forbes; and Bevins was a Vice President at MacAndrews & Forbes.

THE TAKING MFW PRIVATE PROPOSAL

In May 2011, Perelman began to explore the possibility of taking MFW private. At that time, MFW's stock price traded in the $20 to $24 per share range. MacAndrews & Forbes engaged a bank, Moelis & Company, to advise it. After preparing valuations based on projections that had been supplied to lenders by MFW in April and May 2011, Moelis valued MFW at between $10 and $32 a share.

On June 10, 2011, MFW's shares closed on the New York Stock Exchange at $16.96. The next business day, June 13, 2011, Schwartz sent a letter proposal ("Proposal") to the MFW board to buy the remaining MFW shares for $24 in cash. The Proposal stated, in relevant part:

> The proposed transaction would be subject to the approval of the Board of Directors of the Company [i.e., MFW] and the negotiation and execution of mutually acceptable definitive transaction documents. It is our expectation that the Board of Directors will appoint a special committee of independent directors to consider our proposal and make a recommendation to the Board of Directors. We will not move forward with the transaction unless it is approved

> by such a special committee. In addition, the transaction will be subject to a non-waivable condition requiring the approval of a majority of the shares of the Company not owned by M & F or its affiliates. . . . [Emphasis by Supreme Court.]
>
> . . . In considering this proposal, you should know that in our capacity as a stockholder of the Company we are interested only in acquiring the shares of the Company not already owned by us and that in such capacity we have no interest in selling any of the shares owned by us in the Company nor would we expect, in our capacity as a stockholder, to vote in favor of any alternative sale, merger or similar transaction involving the Company. If the special committee does not recommend or the public stockholders of the Company do not approve the proposed transaction, such determination would not adversely affect our future relationship with the Company and we would intend to remain as a long-term stockholder. . . .
>
> In connection with this proposal, we have engaged Moelis & Company as our financial advisor and Skadden, Arps, Slate, Meagher & Flom LLP as our legal advisor, and we encourage the special committee to retain its own legal and financial advisors to assist it in its review.

MacAndrews & Forbes filed this letter with the U.S. Securities and Exchange Commission ("SEC") and issued a press release disclosing substantially the same information.

THE SPECIAL COMMITTEE IS FORMED

The MFW board met the following day to consider the Proposal . . . Schwartz presented the offer on behalf of MacAndrews & Forbes. Subsequently, Schwartz and Bevins recused themselves from the meeting, as did Dawson, the CEO of HCHC, who had previously expressed support for the proposed offer.

The independent directors then invited counsel from Willkie Farr & Gallagher — a law firm that had recently represented a Special Committee of MFW's independent directors in a potential acquisition of a subsidiary of MacAndrews & Forbes — to join the meeting. The independent directors decided to form the Special Committee, and resolved further that:

> [T]he Special Committee is empowered to: (i) make such investigation of the Proposal as the Special Committee deems appropriate; (ii) evaluate the terms of the Proposal; (iii) negotiate with Holdings [i.e., MacAndrews & Forbes] and its representatives any element of the Proposal; (iv) negotiate the terms of any definitive agreement with respect to the Proposal (it being understood that the execution thereof shall be subject to the approval of the Board); (v) report to the Board its recommendations and conclusions with respect to the Proposal, including a determination and recommendation as to whether the Proposal is fair and in the best interests of the stockholders of the Company other than Holdings and its affiliates and should be approved by the Board; and (vi) determine to elect not to pursue the Proposal. . . . [Emphasis by Court.] [T]he Board shall not approve the Proposal without a prior favorable recommendation of the Special Committee. . . .

. . . [T]he Special Committee [is] empowered to retain and employ legal counsel, a financial advisor, and such other agents as the Special Committee shall deem necessary or desirable in connection with these matters. . . .

The Special Committee consisted of Byorum, Dinh, Meister (the chair), Slovin, and Webb. The following day, Slovin recused himself because, although the MFW board had determined that he qualified as an independent director under the rules of the New York Stock Exchange, he had "some current relationships that could raise questions about his independence for purposes of serving on the Special Committee."

[The special committee retained independent bankers and lawyers to advise it and negotiated a transaction with MacAndrews & Forbes. After trying to get the $24 offer up to $30 and failing, the committee agreed to the $25 price. That deal was then presented to the public shareholders and approved. The suit followed promptly.]

ANALYSIS

What Should Be the Review Standard?

Where a transaction involving self-dealing by a controlling stockholder is challenged, . . . the defendants bear the ultimate burden of proving that the transaction with the controlling stockholder was entirely fair to the minority stockholders. In *Kahn* v. *Lynch Communication Systems, Inc.* however, this Court held that in "entire fairness" cases, the defendants may shift the burden of persuasion to the plaintiff if either (1) they show that the transaction was approved by a well-functioning committee of independent directors; or (2) they show that the transaction was approved by an informed vote of a majority of the minority stockholders.

This appeal presents a question of first impression: What should be the standard of review for a merger between a controlling stockholder and its subsidiary, where the merger is conditioned ab initio upon the approval of both an independent, adequately-empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders. The question has never been put directly to this Court.

. . . *Lynch* did not involve a merger conditioned by the controlling stockholder on both procedural protections. The Appellants submit, nonetheless, that statements in *Lynch* and its progeny could be (and were) read to suggest that even if both procedural protections were used, the standard of review would remain entire fairness. However, in *Lynch* and the other cases that Appellants cited, *Southern Peru* and *Kahn v. Tremont*, the controller did not give up its voting power by agreeing to a non-waivable majority-of-the-minority condition. That is the vital distinction between those cases and this one. The question is what the legal consequence of that distinction should be in these circumstances.

The Court of Chancery held that the consequence should be that the business judgment standard of review will govern going private mergers with a controlling stockholder that are conditioned ab initio upon (1) the approval of an independent and fully-empowered Special Committee that fulfills its duty of care and (2) the uncoerced, informed vote of the majority of the minority stockholders.

The Court of Chancery [stated]:

> By giving controlling stockholders the opportunity to have a going private transaction reviewed under the business judgment rule, a strong incentive is created to give minority stockholders much broader access to the transactional structure that is most likely to effectively protect their interests. . . . That structure, it is important to note, is critically different than a structure that uses only one of the procedural protections. The "or" structure does not replicate the protections of a third-party merger under the DGCL approval process, because it only requires that one, and not both, of the statutory requirements of director and stockholder approval be accomplished by impartial decision-makers. The "both" structure, by contrast, replicates the arm's length merger steps of the DGCL by "requir[ing] two independent approvals, which it is fair to say serve independent integrity-enforcing functions."

Before the Court of Chancery, the Appellants acknowledged that "this transactional structure is the optimal one for minority shareholders." Before us, however, they argue that neither procedural protection is adequate to protect minority stockholders, because "possible ineptitude and timidity of directors" may undermine the special committee protection, and because majority-of-the-minority votes may be unduly influenced by arbitrageurs that have an institutional bias to approve virtually any transaction that offers a market premium, however insubstantial it may be. Therefore, the Appellants claim, these protections, even when combined, are not sufficient to justify "abandon[ing]" the entire fairness standard of review.

. . . [T]he Appellants' assertions regarding the MFW directors' inability to discharge their duties are not supported either by the record or by well-established principles of Delaware law. As the Court of Chancery correctly observed:

> Although it is possible that there are independent directors who have little regard for their duties or for being perceived by their company's stockholders (and the larger network of institutional investors) as being effective at protecting public stockholders, the court thinks they are likely to be exceptional, and certainly our Supreme Court's jurisprudence does not embrace such a skeptical view.

Regarding the majority-of-the-minority vote procedural protection, as the Court of Chancery noted, "plaintiffs themselves do not argue that minority stockholders will vote against a going private transaction because of fear of retribution." Instead, as the Court of Chancery summarized, the Appellants' argued as follows:

> [Plaintiffs] just believe that most investors like a premium and will tend to vote for a deal that delivers one and that many long-term investors will sell out when they can obtain most of the premium without waiting for the ultimate vote. But

that argument is not one that suggests that the voting decision is not voluntary, it is simply an editorial about the motives of investors and does not contradict the premise that a majority-of-the-minority condition gives minority investors a free and voluntary opportunity to decide what is fair for themselves.

Business Judgment Review Standard Adopted

We hold that business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned ab initio upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders. We so conclude for several reasons.

First, entire fairness is the highest standard of review in corporate law. It is applied in the controller merger context as a substitute for the dual statutory protections of disinterested board and stockholder approval, because both protections are potentially undermined by the influence of the controller. However, as this case establishes, that undermining influence does not exist in every controlled merger setting, regardless of the circumstances. The simultaneous deployment of the procedural protections employed here create a countervailing, offsetting influence of equal — if not greater — force. That is, where the controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations and the shareholder vote, the controlled merger then acquires the shareholder-protective characteristics of third-party, arm's length mergers, which are reviewed under the business judgment standard.

Second, the dual procedural protection merger structure optimally protects the minority stockholders in controller buyouts. As the Court of Chancery explained:

> [W]hen these two protections are established up-front, a potent tool to extract good value for the minority is established. From inception, the controlling stockholder knows that it cannot bypass the special committee's ability to say no. And, the controlling stockholder knows it cannot dangle a majority-of-the-minority vote before the special committee late in the process as a deal-closer rather than having to make a price move.

Third, . . . applying the business judgment standard to the dual protection merger structure: . . . is consistent with the central tradition of Delaware law, which defers to the informed decisions of impartial directors, especially when those decisions have been approved by the disinterested stockholders on full information and without coercion. Not only that, the adoption of this rule will be of benefit to minority stockholders because it will provide a strong incentive for controlling stockholders to accord minority investors the transactional structure that respected scholars believe will provide them the best protection, a structure where stockholders get the benefits of independent, empowered negotiating agents to bargain for the best price and say no if the agents believe the deal is not advisable for any proper reason, plus the critical ability to determine for themselves whether to accept any deal that their negotiating agents recommend to them. A transactional structure with both these protections is fundamentally different from one with only one protection. [Emphasis by court.]

Fourth, the underlying purposes of the dual protection merger structure utilized here and the entire fairness standard of review both converge and are fulfilled at the same critical point: price. Following *Weinberger v. UOP, Inc.*, this Court has consistently held that, although entire fairness review comprises the dual components of fair dealing and fair price, in a non-fraudulent transaction "price may be the preponderant consideration outweighing other features of the merger." The dual protection merger structure requires two price-related pretrial determinations: first, that a fair price was achieved by an empowered, independent committee that acted with care;[13] and, second, that a fully-informed, uncoerced majority of the minority stockholders voted in favor of the price that was recommended by the independent committee.

The New Standard Summarized

To summarize our holding, in controller buyouts, the business judgment standard of review will be applied if and only if: (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.[14]

If a plaintiff that can plead a reasonably conceivable set of facts showing that any or all of those enumerated conditions did not exist, that complaint would state a claim for relief that would entitle the plaintiff to proceed and conduct discovery. If, after discovery, triable issues of fact remain about

13. In *Americas Mining*, for example, it was not possible to make a pretrial determination that the independent committee had negotiated a fair price. After an entire fairness trial, the Court of Chancery held that the price was not fair. See *Ams. Mining Corp. v. Theriault*, 51 A.3d 1213, 1241-44 (Del. 2012).

14. The Verified Consolidated Class Action Complaint would have survived a motion to dismiss under this new standard. First, the complaint alleged that Perelman's offer "value[d] the company at just four times" MFW's profits per share and "five times 2010 pre-tax cash flow," and that these ratios were "well below" those calculated for recent similar transactions. Second, the complaint alleged that the final Merger price was two dollars per share lower than the trading price only about two months earlier. Third, the complaint alleged particularized facts indicating that MFW's share price was depressed at the times of Perelman's offer and the Merger announcement due to short-term factors such as MFW's acquisition of other entities and Standard & Poor's downgrading of the United States' creditworthiness. Fourth, the complaint alleged that commentators viewed both Perelman's initial $24 per share offer and the final $25 per share Merger price as being surprisingly low. These allegations about the sufficiency of the price call into question the adequacy of the Special Committee's negotiations, thereby necessitating discovery on all of the new prerequisites to the application of the business judgment rule.

whether either or both of the dual procedural protections were established, or if established were effective, the case will proceed to a trial in which the court will conduct an entire fairness review.

This approach is consistent with *Weinberger*, *Lynch*, and their progeny. A controller that employs and/or establishes only one of these dual procedural protections would continue to receive burden-shifting within the entire fairness standard of review framework. Stated differently, unless both procedural protections for the minority stockholders are established prior to trial, the ultimate judicial scrutiny of controller buyouts will continue to be the entire fairness standard of review.

Having articulated the circumstances that will enable a controlled merger to be reviewed under the business judgment standard, we next address whether those circumstances have been established as a matter of undisputed fact and law in this case.

[The Court then affirms the Court of Chancery opinion that no issue of material fact had been raised by the plaintiffs on the motion for summary judgment respecting the independence and disinterestedness of the members of the special committee, its due empowerment, or its due care in proceeding to approve the merger. The Supreme Court then affirmed the Chancellor's determination that disclosure was full and fair and that the shareholders were not coerced. . . .

Both Procedural Protections Established

Based on a highly extensive record, the Court of Chancery concluded that the procedural protections upon which the Merger was conditioned — approval by an independent and empowered Special Committee and by an uncoerced, informed majority of MFW's minority stockholders — had both been undisputedly established prior to trial. We agree and conclude the Defendants' motion for summary judgment was properly granted on all of those issues.

Business Judgment Review Properly Applied

We have determined that the business judgment rule standard of review applies to this controlling stockholder buyout. Under that standard, the claims against the Defendants must be dismissed unless no rational person could have believed that the merger was favorable to MFW's minority stockholders. In this case, it cannot be credibly argued (let alone concluded) that no rational person would find the Merger favorable to MFW's minority stockholders.

CONCLUSION

For the above-stated reasons, the judgment of the Court of Chancery is affirmed.