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The Unimportance of Being Earnest: Paramount Rewrites the Rules for Enhanced Scrutiny in Corporate Takeovers

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The Unimportance of Being Earnest: *Paramount* Rewrites the Rules for Enhanced Scrutiny in Corporate Takeovers

by
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Introduction

With its February 1994 decision in *Paramount Communications v. QVC Network*,[1] the Delaware Supreme Court made yet another noteworthy contribution to the law of corporate takeovers. The court's opinion builds substantially on a decade's foundation of major corporate governance cases and undoubtedly will serve as the definitive precedent by which the conduct of directors will be assessed in future takeover cases.[2]

In affirming the Court of Chancery's decision to enjoin various defensive measures, stock options, and other devices that impeded a fair auction for control of Paramount Communications, the court declared that its analysis was "well-established" by its prior decisions.[3] To be sure, the decision may be construed as a straightforward application of principles announced in *Unocal* and *Revlon*.[4] But such a

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1. 637 A.2d 34 (Del. 1994). The Delaware Supreme Court previously had issued an order affirming the decision of the Chancery Court. *Id.* at 36 n.1.

2. *Id.* at 51 ("The holding of this case on its facts, coupled with the holdings of the principal cases discussed herein where the issue of sale of control is implicated, should provide a workable precedent against which to measure future cases.").

3. *Id.* at 43; *see also id.* at 46, 51.

4. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). That is, (i) defensive measures will be subjected to enhanced judicial scrutiny and (ii) the directors' narrowly

reading misses the import of the decision, namely, the emphasis the court places on the significance of change-of-control transactions to shareholders.[5] Accompanying this new emphasis on transaction significance is the corresponding unimportance—at least for purposes of determining whether to apply enhanced scrutiny—ascribed to the directors' care, disinterestedness, and good faith in earnestly seeking the best available transaction. This article argues that *Paramount*'s formulation of the test for enhanced judicial scrutiny represents an unwarranted intrusion into the managerial authority of the board of directors.

The Delaware Supreme Court announced in *Paramount* that enhanced scrutiny will be applied to assess both the process and the substantive results of director decision making in every change-of-control case.[6] Significantly, the court chose not to limit enhanced scrutiny to those instances of director conduct that raise suspicion about the directors' motivations, such as a target board's adoption of defensive measures[7] or unequal treatment of competing bidders.[8] Such threshold concerns about directors' motivations and good faith have been replaced with an all-encompassing concern for (i) the significance of a takeover to the corporation's owners and (ii) the perceived need to "ensure" a "reasonable" outcome.[9] Accordingly, instead of relying on the "omnipresent specter" of potential self-interest ascribed to all directors "where issues of corporate control are at stake,"[10] the court articulated a new rationale.

Essentially, the *Paramount* court's rationale for applying enhanced scrutiny in every corporate takeover case is as follows: A board's decision to sell control represents a unique opportunity for shareholders to receive maximum value for their investment;[11] accord-

focused and primary obligation in a change-of-control context is to "maximiz[e] . . . the company's value at a sale for the stockholders' benefit." *Unocal*, 493 A.2d at 954-55; *accord Revlon*, 506 A.2d at 182.

5. The *Paramount* decision also is noteworthy for its helpful clarification of the circumstances under which *Revlon* duties are triggered. *See infra* Part IV.B(2).

6. *Paramount*, 637 A.2d at 42, 43, 45, 47-48.

7. *E.g.*, *Unocal*, 493 A.2d 946; Moran v. Household Int'l, Inc., 500 A.2d 1346, 1355-57 (Del. 1985); *Revlon*, 506 A.2d at 179-81; Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1342-44 (Del. 1987); *see also infra* Part II.B.

8. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1989).

9. *Paramount*, 637 A.2d at 43, 45.

10. *Macmillan*, 559 A.2d at 1287; *see also Unocal*, 493 A.2d at 954.

11. *Paramount*, 637 A.2d at 43, 45, 47-48. The court also emphasized the "significant diminution in the voting power" of shareholders who find themselves in the minority of a corporation that has come under majority ownership "by a single person or entity, or by a cohesive group acting together . . . ." *Id.* at 42; *see also id.* at 43, 45. The court's novel

ingly, even if a selling corporation's directors adopt no defensive measures and treat all bidders equally, the court will nevertheless act as an "oversee[r]" of the board's decisions to "ensure that the directors have acted reasonably."[12] *Paramount* thus states without apology that Delaware courts will review "the substantive merits of a board's actions" by evaluating, among other things, whether the "directors' decision was, on balance, within a range of reasonableness."[13]

This formulation has disturbing ramifications for the business judgment rule and its vital role as a mechanism for accommodating the "twin objectives of managerial freedom of action and responsibility to shareholders."[14] As Professor Dooley has explained, there is a tension between these twin objectives—the "antithetical" values of board authority (judicial deference) and responsibility to shareholders (judicial review)—because "more of one means less of the other."[15] Yet, "any feasible governance system must and does contain elements of both" values; accordingly, the "question of mix is critical."[16] The *Paramount* decision may represent a new judicial activism in Delaware and a shift toward a model of corporate governance which un-

reliance on voting rights cases to further justify enhanced scrutiny in all change-of-control transactions is discussed in Part IV.

12. *Paramount*, 637 A.2d at 42, 43. The court's emphasis on transaction significance also pervaded its discussion of the directors' *Revlon* duties in change-of-control transactions:

> There are few events that have a more significant impact on the stockholders than a sale of control or a corporate breakup. Each event represents a fundamental (and perhaps irrevocable) change in the nature of the corporate enterprise from a practical standpoint. It is the significance of *each* of these events that justifies: (a) focusing on the directors' obligation to seek the best value reasonably available to the stockholders; and (b) requiring a close scrutiny of board action which could be contrary to the stockholders' interest.

Id. at 47-48.

13. *Id.* at 45.

14. Aronson v. Lewis, 473 A.2d 805, 811 n.4 (Del. 1984); *see also id.* at 812; Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) ("The [business judgment] rule operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation."); Michael P. Dooley, *Two Models of Corporate Governance*, 47 Bus. Law. 461, 471 (1992) (the business judgment rule "must not only protect the authority of the board, but, given the necessity of both Authority and Responsibility, it must also attempt to achieve some accommodation between the two conflicting values").

15. Dooley, *supra* note 14, at 464.

16. *Id.* at 463-64. As Professor Dooley explains: "If the board is never made accountable for its decisions, it is liable to exercise its powers irresponsibly vis-a-vis the shareholders. On the other hand, the power to hold a party accountable is the power to interfere and, ultimately, the power to decide." *Id.* at 470.

duly emphasizes responsibility to shareholders at the expense of managerial authority, freedom, and innovation.[17]

Through the vehicle of the *Paramount* decision, this article examines anew Delaware's enhanced scrutiny test and the developing rationale for its application in all change-of-control transactions. Part I begins this analysis with an examination of the business judgment rule and the traditional justifications for judicial deference to the business decisions of informed and disinterested boards of directors. Part II discusses the early development of the enhanced scrutiny test, from its announcement in *Unocal* in 1985 through a flurry of takeover cases that culminated with *In re RJR Nabisco, Inc. Shareholders Litigation*,[18] a 1989 Chancery Court decision involving the largest takeover in history.[19] Part III examines the enhanced scrutiny test for change-of-control transactions from the perspective of *Macmillan* and its progeny. Although not entirely clear on the issue, *Macmillan* appeared to announce that *Unocal*'s enhanced scrutiny test also would apply to evaluate the conduct of directors in an auction for corporate control.[20]

17. Whether a new judicial activism is in fact emerging in Delaware remains to be seen. Nevertheless, it is worth noting that the Delaware Supreme Court recently has announced a number of decisions, including its order affirming the Chancery Court's decision in *Paramount*, that were decidedly favorable to the interests of litigation-minded shareholders. *See, e.g.*, Kahn v. Lynch Communication Sys., 638 A.2d 1110, 1122 (Del. 1994) (reversing judgment entered by Chancery Court in favor of defendants in cash-out merger transaction and directing "redetermination" of entire fairness of merger to shareholder plaintiffs and other minority shareholders); *Cede*, 634 A.2d at 345 (reversing a Chancery Court judgment in favor of Technicolor directors who had approved a merger transaction with MacAndrews & Forbes and ordering that directors' conduct be subjected on remand to the entire fairness test); Rales v. Blasband, 634 A.2d 927 (Del. 1993) (addressing certified question from federal district court and finding demand excused in double derivative suit); *In re* Tri-Star Pictures Litig., 634 A.2d 319 (Del. 1993) (reversing Chancery Court's dismissal of shareholder class action complaint attacking allegedly wasteful corporate transaction that occurred prior to cash-out merger); Paramount Communications v. QVC Network, Nos. 427, 1993 & 428, 1993 (Del. Dec. 9, 1993) (order) (affirming order of Chancery Court preliminarily enjoining various defensive measures deployed in connection with Viacom's proposed acquisition of Paramount).

18. C.A. No. 10389, 1990 Del. Ch. LEXIS 73 (Del. Ch. Jan. 31, amended Feb. 14, 1989), *appeal refused*, 556 A.2d 1070 (Del. 1989).

19. Deborah A. DeMott, *The Biggest Deal Ever*, 1989 DUKE L.J. 1 (1989) ("The contest for ownership and control of RJR Nabisco, Inc. . . . resulted in the largest corporate control transaction in the United States to date.").

20. Mill Acquisition Co. v. Macmillan, 559 A.2d 1261, 1287 (Del. 1989). Significantly, in *Macmillan* and the opinions that followed, the court continued to justify such scrutiny based on "omnipresent" concerns with directors' motives "where issues of corporate control are at stake . . . ." *Id.* at 1287 (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)).

Lastly, Part IV examines the *Paramount* decision and concludes that the Delaware Supreme Court has inappropriately expanded the role of the courts by requiring judicial assessment of the wisdom of directors' decisions in all corporate takeovers. This article argues that the undisputed significance of a change-of-control transaction is, without more, an insufficient doctrinal basis to displace the deference otherwise accorded to decisions made in good faith by informed and disinterested directors, even in the context of a corporate takeover. To be sure, the significance of a change of control to the corporation's owners requires that directors earnestly strive to achieve what they advisedly and in good faith believe is the best result for shareholders. But it does not follow from a finding of "importance" or "significance" that the business judgment rule—with its foundational requirements of director care and loyalty—is inadequate to protect shareholders' interests in this context.

Enhanced judicial scrutiny should be reserved for director conduct that raises a reasonable doubt about the directors' motivations, such as the use of defensive measures to thwart a takeover or the disparate treatment of competing bidders in an auction. Absent some such identifiable reason to question the directors' bona fides, enhanced scrutiny should not be applied. In other words, the fact that a sale or change of control is important is no reason to assume that an informed and disinterested board is prone to dysfunction and failure.

I. The Business Judgment Rule and the Justifications for Deference

It is a "cardinal precept" of Delaware law "that directors, rather than shareholders, manage the business and affairs of the corporation."[21] This foundational principle, codified in the Delaware General

Neither *Macmillan* nor the cases that followed (until *Paramount*) explicitly stated that enhanced scrutiny was required in this context because of the importance of change-of-control transactions to shareholders' interests. *See infra* Part III. *Compare Macmillan*, 559 A.2d at 1287 (citing concern—as basis for application of enhanced scrutiny—that "board may be acting primarily in its own interests" where "issues of corporate control are at stake") *with id.* at 1281 (noting that while a board may rely in good faith on information furnished by others, it "may not avoid its active and direct duty of oversight in a matter as significant as the sale of corporate control").

21. Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); *see also Cede*, 634 A.2d at 360 ("Our starting point is the fundamental principle of Delaware law that the business and affairs of a corporation are managed by or under the direction of its board of directors."); Spiegel v. Buntrock, 571 A.2d 767, 772-73 (Del. 1990) ("[D]irectors, rather than shareholders, manage the business and affairs of the corporation."); Revlon, Inc. v. MacAndrews &

Corporation Law,[22] serves as the analytical starting point for virtually all of the major Delaware Supreme Court decisions involving issues of corporate governance.[23]

The business judgment rule,[24] an "extension" of this bedrock organizational principle,[25] provides for "great deference" by the courts to the "managerial decisions of . . . directors."[26] Through the opera-

Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986) ("The ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors.").

22. The Delaware Code provides in pertinent part: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." DEL. CODE ANN. tit. 8, § 141(a) (1991).

23. *See, e.g.,* Paramount Communications v. QVC Network, 637 A.2d 34, 41-42 (Del. 1994); *Cede*, 634 A.2d at 360; Paramount Communications v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1990) ("*Time-Warner*"); *Macmillan*, 559 A.2d at 1280; Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987); *Revlon*, 506 A.2d at 179; *Unocal*, 493 A.2d at 953.

24. Commentators have suggested that the business judgment *rule* protects directors and management from personal liability for their business decisions, while the business judgment *doctrine* protects the decision itself from being invalidated. *See* Joseph Hinsey IV, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, The Doctrine, and The Reality*, 52 GEO. WASH. L. REV. 609, 611-13 (1984); Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 323 n.26 (1987) (similarly differentiating between the business judgment rule and the business judgment doctrine); E. Norman Veasey, *The New Incarnation of the Business Judgment Rule in Takeover Defenses*, 11 DEL. J. CORP. L. 503, 505-06 (1986) (suggesting that the degree of deference accorded to directors' decisions under the business judgment rule "may differ substantially" in a "transactional justification" setting in which injunctive relief is sought); Thomas C. Pelto, Sr., Note, *False Halo: The Business Judgment Rule in Corporate Control Contests*, 66 TEX. L. REV. 843, 850 n.40 (1988) (arguing that the courts should repudiate the business judgment rule only in takeover cases in which shareholders seek injunctive relief). As noted in *Revlon*, the Delaware courts have not observed this distinction in terminology—between the business judgment rule and the business judgment doctrine—in "transactional justification cases . . . ." *Revlon*, 506 A.2d at 180 n.10. This article will use the term "business judgment rule" to embrace both concepts.

25. *Cede*, 634 A.2d at 360; *see also* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("[T]he business judgment rule is the offspring of the fundamental principle, codified in 8 *Del. C.* § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors."); *Aronson*, 473 A.2d at 812 ("The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a).").

26. *Paramount*, 637 A.2d at 42, 45 n.17. Section 4.01(c) of the American Law Institute's PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS articulates the business judgment rule as follows:

> (c) A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer:
>
> (1) is not interested [§ 1.23] in the subject of the business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and

tion of the business judgment rule, "neither the courts nor the stockholders" are in a position to "interfere," through litigation, with the decisions of the directors.[27]

> (3) rationally believes that the business judgment is in the best interests of the corporation.

AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) (1994) [hereinafter "ALI GOVERNANCE PROJECT"]. The REVISED MODEL BUSINESS CORPORATION ACT plainly supports a more deferential business judgment rule than that which the ALI GOVERNANCE PROJECT envisions. *See* REVISED MODEL BUSINESS CORPORATION ACT § 8.30, Official Comment (3d ed. 1993) [hereinafter "RMBCA"]. The RMBCA does not attempt to codify the rule, however, because "[t]he elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts." *Id.* at 221.

Professor Dooley has criticized the ALI GOVERNANCE PROJECT's formulation of the business judgment rule because it improperly invites a judicial assessment of the wisdom of the directors' decisions:

> The use of the phrase "rationally believes" in subsection (c)(3) signals an even more consequential deviation from existing law because it calls for an evaluation of the directors' *judgment*, thereby effectively shredding the business judgment rule. To the extent that "rational" is to be equated with "reasonable," the trier of fact is invited to second-guess not only the procedural aspects of the decision, but its substantive soundness as well. In that event, the business judgment rule becomes meaningless, and the test for negligent management becomes the same as the test for negligent operation of a motor vehicle.

Dooley, *supra*, note 14, at 478 (footnote omitted).

27. *Paramount*, 637 A.2d at 42; *see also Cede*, 634 A.2d at 360 ("[T]he [business judgment] rule operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation."); Dennis J. Block et al., *The Duty of Loyalty and the Evolution of the Scope of Judicial Review*, 59 BROOK. L. REV. 65, 67 (1993) ("In general terms, under the *business judgment rule*, courts will not interfere with a business decision if it is made in good faith by disinterested directors after reasonable investigation and does not constitute an abuse of discretion."); Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decisionmaking—Some Theoretical Perspectives*, 80 NW. U. L. REV. 1, 60 (1985) ("[F]or most intents and purposes, the [business judgment] rule operates to safe harbor disinterested corporate decisionmakers from attacks on the basic wisdom of their decisions."); Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: Bridging the Unocal/Revlon Gap*, 35 ARIZ. L. REV. 989, 991 n.10 (1993) ("Under the business judgment rule, the board prevails whenever it can articulate a rational, unselfish business purpose for its actions.").

The business judgment rule has been described by the Delaware Supreme Court as "both a procedural guide for litigants and a substantive rule of law." Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989). As a procedural matter, the business judgment rule creates an evidentiary "'presumption that in making a business decision, the directors of a corporation acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was in the best interest of the company.'" *Citron*, 569 A.2d at 64 (quoting *Aronson*, 473 A.2d at 812). Consequently, a shareholder plaintiff challenging the actions of a board of directors has the initial burden to rebut the rule's "powerful presumption in favor of actions taken by the directors . . . ." *Cede*, 634 A.2d at 361. The plaintiff thus is charged at the outset with the "burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty—good faith, loyalty or due care." *Id.* In *Citron*, the Delaware Supreme Court described a shareholder plaintiff's evidentiary burden in this regard as follows: "The burden falls upon the proponent of a claim to rebut the presumption

A. The Rationale for Deference

Many reasons have been advanced for the great deference accorded to directors' decisions. As discussed below, courts frequently explain this deference as a recognition of their own lack of competency to assess the wisdom of business decisions.[28] A more compelling rationale is that the business judgment rule encourages entrepreneurial risk-taking by directors and upholds the board's authority as centralized decisionmaker for the firm.[29]

(1) The Professed Concern for Judicial Competency

Courts routinely explain the deference they accord to directors' decisions as a recognition of their "institutional incompetence . . . to pass upon the wisdom of business decisions."[30] Some commentators

by introducing evidence either of director self-interest, if not self-dealing, or that the directors either lacked good faith or failed to exercise due care." *Citron*, 569 A.2d at 64. The substantive aspect of the business judgment rule is triggered when a plaintiff fails to provide evidence sufficient to overcome the rule's presumption of propriety with regard to director decision-making. If the plaintiff's evidence is found wanting, "the business judgment rule, as a substantive rule of law, will attach to protect the directors and the decisions they make." *Id.* In that event, the court will give "great deference to the substance of the directors' decision and will not invalidate the decision . . . [and] will not examine its reasonableness . . . ." *Paramount*, 637 A.2d at 45 n.17; *see also Cede*, 634 A.2d at 361. As Professor Dooley has explained, "the rule precludes judicial review of board decisions that are honest and carefully thought out, but just plain wrong from the standpoint of advancing the shareholders' interests." Dooley, *supra* note 14, at 470. Consequently, a board's decision will be disturbed in this context only if it "cannot be 'attributed to any rational business purpose.'" *Cede*, 634 A.2d at 361 (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)); *see also Unocal*, 493 A.2d at 954 ("A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'"). Chancellor Allen has described this language as an "escape hatch" test in which the court reviews the substance of a board's business decision "for the limited purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." *In re* J.P. Stevens & Co. Shareholders Litig., 542 A.2d 770, 780-81 & n.5 (Del. Ch. 1988).

28. *See infra* notes 30-32 and accompanying text.

29. *See infra* notes 33-42 and accompanying text.

30. Freedman v. Restaurant Assocs. Indus., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502, at 97,220 (Del. Ch. Oct. 16, 1987); *see also* Nixon v. Blackwell, 626 A.2d 1366, 1378 n.14 (Del. 1993) ("courts are 'ill-equipped' to make business decisions") (quoting Auerbach v. Bennett, 419 N.Y.S.2d 920, 926-28 (N.Y. 1979)); Paramount Communications v. Time Inc., C.A. No. 10866 (Del. Ch. July 14, revised July 17, 1989), *reprinted in* 15 DEL. J. CORP. L. 700, 748 (1990) [hereinafter "*Paramount Communications*"] ("[T]he important benefits of the business judgment rule . . . includ[e] designation of authority to make business and financial decisions to agencies, *i.e.*, boards of directors, with substantive expertise."), *aff'd*, 571 A.2d 1140 (Del. 1990); Solash v. Telex Corp., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608, at 97,727 (Del. Ch. Jan. 19, 1988) ("[B]usinessmen and women are correctly perceived as possessing skills, information and

have criticized this competency rationale as unpersuasive, given the willingness of the courts to tread into other disciplines that involve as much complexity as managing the affairs of a public company and require analyses of matters in which the courts' expertise presumably is no greater.[31] In their thoughtful discussion on this subject, Professor Dooley and then practitioner Norman Veasey (now Chief Justice of the Delaware Supreme Court and author of *Paramount*) astutely observe that the competency rationale "rings false to those who are accustomed to seeing courts take over the administration of entire school and prison systems . . . ."[32]

(2) Entrepreneurial Risk-Taking

A more persuasive rationale for deference is that the business judgment rule is intended to encourage innovation and entrepreneurial risk-taking by corporate officers and directors.[33] Seen in

judgment not possessed by reviewing courts."); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) ("This deference—the business judgment rule—is, of course, simply a recognition of the allocation of responsibility made by section 141(a) of the General Corporation Law and of the limited institutional competence of courts to assess business decisions."); Dennis Honabach & Roger Dennis, *The Seventh Circuit and the Market for Corporate Control*, 65 CHI.-KENT L. REV. 681, 686 (1989) ("[C]ourts frequently announce that they are reluctant to review the acts of directors because they lack the expertise to evaluate the wisdom of business decisions."); Dennis J. Block et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 BUS. LAW. 469, 490 (1990) ("[T]he [business judgment] rule keeps courts from becoming enmeshed in complex corporate decisionmaking, a task which they are admittedly ill-equipped to handle.").

31. *E.g.*, Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1439 (1985) (notion "that judges lack competence in making business decisions" does "not explain . . . why the same judges who presumably are able to resolve other commercial disputes are unable to decide whether a business decision was made negligently"); Note, *"What's in a Name?": The Business Judgment Rule After Zapata Corp. v. Maldonado*, 34 CASE W. RES. L. REV. 340, 346-47 (1984) (explaining that courts defer to a board's decision not because "directors are blessed with a special business acumen" but rather because deference "foster[s] proper and efficient corporate management").

32. Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation*, 44 BUS. LAW. 503, 521 (1989); *see also* R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1342 (1993) ("Courts readily plunge into many areas, *e.g.*, construction, ecology, and accounting, where they have only limited or no experience and where their expertise, if any, is not obvious.").

33. Dooley & Veasey, *supra* note 32, at 521. The introductory note to the ALI Governance Project's discussion of the business judgment rule likewise explains the rule as encouraging entrepreneurial activity:

> The basic policy underpinning of the business judgment rule is that corporate law should encourage, and afford broad protection to, informed business judgments (whether subsequent events prove the judgments right or wrong) in order to stimulate risk taking, innovation, and other creative entrepreneurial activities. Shareholders accept the risk that an informed business decision—honestly undertaken

this light, the business judgment rule promotes a policy which presumes that investors in a company—and perhaps society as a whole—benefit by encouraging talented people to pursue their managerial vision unfettered by the fear that courts, with the benefit of 20/20 hindsight, will find their decisions to have been flawed.[34]

> and rationally believed to be in the best interests of the corporation—may not be vindicated by subsequent success.

AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, Part IV (Duty of Care and The Business Judgment Rule), Introductory Note, at 135 (1994); *see also* Davis, *supra* note 27, at 75 (explaining that the business judgment rule "promot[es] managerial creativity and risk-taking by removing the risk of liability for decisions that turn out poorly"); Frank H. Easterbrook & Gregg A. Jarrell, *Do Targets Gain From Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277 (1984) ("The business judgment rule gives managers the freedom to err, and thus it facilitates risk-taking."); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1491 (1984) ("Sophisticated modern courts further explicitly recognize that the private sector entrepreneurial process cannot operate unless managers are given the latitude to be innovative and experimental and, therefore, to make mistakes."); Daniel J. Morrissey, *Defensive Tactics In Tender Offers—Does Anything Go?*, 53 TENN. L. REV. 103, 120 (1985) ("Judges, illsuited to re-examining complex commercial decisions and fearful of fostering overly cautious business planning, have routinely deferred to the mercantile decisions of corporate management."); Comment, *Judicial Review of Antitakeover Devices Employed in the Noncoercive Tender Offer Context: Making Sense of the* Unocal *Test*, 138 U. PA. L. REV. 225, 240 (1989) (noting that the business judgment rule encourages informed risk-taking by directors by protecting them from personal liability for their decisions); Mary A. Lopatto, Note, Hasan v. Clevetrust Realty Investors*: The Business Judgment Rule and Procedural Review of the Special Litigation Committee*, 34 CATH. U. L. REV. 791 (1985) ("[T]he rule is based on the notion that directors, in the course of performing duties on behalf of a corporation, take risks and make mistakes for which they should not be held legally accountable.") Pelto, *supra* note 24, at 846 ("[T]he rule encourages informed risk taking by directors because it shields them from personal liability for honest, informed judgments."); *see also* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("Business judgment rule exists to protect and promote full and free exercise of managerial power granted to . . . directors.").

34. *See* Balotti & Hanks, *supra* note 32, at 1342 ("More persuasive reasons for the rule are its role in encouraging qualified men and women to serve as directors and motivating them to be willing to take entrepreneurial risks."); Block et al., *supra* note 30, at 490 ("[T]he rule recognizes that business decisions frequently entail risk, and thus provides directors the broad discretion they need in formulating dynamic and effective company policy without fear of judicial second-guessing."); Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 444 (1993) ("It is often in the interests of shareholders that directors or officers choose the riskier of two alternative decisions, because the expected value of a more risky decision may be greater than the expected value of the less risky decision."); Honabach & Dennis, *supra* note 30, at 686 (noting the argument "that increased scrutiny will force directors and officers to adopt overly conservative business policies"); *cf.* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 270 (1986) ("If agents are penalized for poor outcomes, as well as poor performance, they will tend to undertake lower risk projects.") (footnote omitted). In Solash v. Telex, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608 (Del. Ch. Jan. 19, 1988), Chancellor Allen articulated a justification

This policy effectively recognizes that the rewards of such risk-taking are more readily realized when the threat of liability does not loom simply because a decision may turn out badly.[35] The Official Comment to Section 8.30 of the RMBCA expresses this concept well:

> [T]he courts recognize that boards of directors and corporate managers continuously make decisions that involve the balancing of risks and benefits for the enterprise. Although some decisions turn out to be unwise or the result of a mistake of judgment, it is unreasonable to reexamine these decisions with the benefit of hindsight.[36]

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for deference that appeared to combine the competency rationale with the value of promoting such entrepreneurial innovation:

> Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith.

Id. at 97,727.

35. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1196 (1981) (noting the profit-reducing cost of obtaining complete information for every business decision and the likely shareholder attack on any decision with a bad outcome on the basis that the managers purportedly "gathered too little information.") Moreover, as Chancellor Allen astutely observed in *Time-Warner*, any number of variables, even luck, can affect the outcome of a business decision, and Delaware law squarely places the authority for making such decisions on the board of directors:

> The value of a shareholder's investment, over time, rises or falls chiefly because of the skill, judgment and perhaps luck—for it is present in all human affairs—of the management and directors of the enterprise. When they exercise sound or brilliant judgment, shareholders are likely to profit; when they fail to do so, share values likely will fail to appreciate. In either event, the financial vitality of the corporation and the value of the company's shares is in the hands of the directors and managers of the firm.

Paramount Communications v. Time Inc., C.A. No. 10866, 1989 Del. Ch. LEXIS 77, at 88-89 (Del. Ch. July 14, revised July 17, 1989), *aff'd*, 571 A.2d 1140 (Del. 1990).

36. RMBCA § 8.30, Official Comment; *see also id.* ("[RMBCA] Section 8.30 defines the general standard of conduct for directors. It sets forth the standard by focusing on the manner in which the director performs his duties, not in the correctness of his decisions."); Eisenberg, *supra* note 34, at 444 ("Under a reasonableness standard of review . . . factfinders might too often erroneously treat decisions that turned out badly as bad decisions, and unfairly hold directors and officers liable for such decisions."); Comment, *supra* note 33, at 240 ("[A]ny evaluation made by the courts will have the benefit of hindsight, necessarily distorting judicial perception of the situation faced by the directors."); Pelto, *supra* note 24, at 846 (explaining that the rule "discourages courts from evaluating business decisions in hindsight").

(3) The Board as Centralized Decisionmaker

Related to the value of entrepreneurial risk-taking is the "value of centralized decisionmaking for the stockholders."[37] Professor Dooley and former-practitioner Veasey thus have emphasized that the business judgment rule operates to protect stockholders from each other by preventing "unwarranted interference" by one or a few stockholders in the board's management of the enterprise:

> The power to hold to account is the power to interfere and, ultimately, the power to decide. If stockholders are given too easy access to courts, the effect is to transfer decision-making power from the board to the stockholders or, more realistically, to one or a few stockholders whose interests may not coincide with those of the larger body of stockholders .... Although it is customary to think of the business judgment rule as protecting directors from stockholders, it ultimately serves the more important function of protecting stockholders from themselves.[38]

To afford stockholders easy access to the courts would, as Chancellor Allen has remarked elsewhere, "make of courts super-directors."[39]

37. Dooley & Veasey, *supra* note 32, at 522; *see also* TW Servs. v. SWT Acquisition Corp., Nos. 10427 & 10298, 1989 Del. Ch. LEXIS 19, at 27-29 n.14 (Del. Ch. Mar. 2, 1989), *reprinted in* 14 DEL. J. CORP. L. 1169, 1186 (1989) ("While corporate democracy is a pertinent concept, a corporation is not a New England town meeting; directors, not stockholders, have responsibilities to manage the business and affairs of the corporation, subject however to a fiduciary obligation . . . ."); *cf.* Commonwealth Assocs. v. Providence Health Care, Inc., C.A. No. 13135, 1993 Del. Ch. LEXIS 231, at *25 (Del. Ch. Oct. 22, 1993) ("In a technological, market economy these corporate enterprises require broad power and discretion in the hands of boards and managers in order to enable the enterprise to adapt to changing markets in a timely way."); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1288 (1982) (describing business judgment rule as embodiment of principle that directors, as managers constrained by discipline of the capital markets—rather than judges, who are not similarly constrained—should make business decisions); Fischel & Bradley, *supra* note 34, at 283 (noting that business judgment rule recognizes, among other things, "the specialization of function in public corporations whereby managers are entrusted to make business decisions and shareholders rather than managers bear business risks"); Morrissey, *supra* note 33, at 120 ("[T]he business judgment rule has been aptly justified as an acknowledgment of the board's managerial prerogatives.") (footnote omitted).

38. Dooley & Veasey, *supra* note 32, at 522. Given this earlier emphasis on the value of avoiding stockholder interference with board decisions (and thereby protecting stockholders from themselves), it is worth noting Chief Justice Veasey's exposition of the business judgment rule along these general lines in the *Paramount* decision. *Compare* Paramount Communications v. QVC Network, 637 A.2d 34, 42 (Del. 1994) ("Under normal circumstances, *neither the courts nor the stockholders* should interfere with the managerial decisions of the directors.") (emphasis added) *with* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) ("The [business judgment] rule operates *to preclude a court* from imposing itself unreasonably on the business and affairs of a corporation.").

39. *In re* RJR Nabisco, Inc. Shareholders Litig., C.A. No. 10389, 1989 Del. Ch. LEXIS 9, at *41 (Del. Ch. Jan. 31, amended Feb. 14, 1989).

According to Professor Dooley, "[t]he business judgment rule can only be understood as intended to protect the authority of the board and thus to promote the value of Authority."[40] The rule achieves this objective by sharply limiting those instances in which shareholders will be permitted to enlist the court's aid to interfere with the board's decisions.[41] In short, courts are reluctant to second-guess business decisions that go awry, but not because judges are ostensibly less qualified than directors to make business decisions. The point is that the courts are certainly no better qualified than directors in such matters and the corporation law vests the directors—not the courts *or* the shareholders—with the authority to make managerial decisions for the firm.[42]

(4) Summary

The courts' oft-cited rationale of judicial incompetency regarding complex business judgments has been discredited as "nearly indefensible."[43] The more persuasive explanations for the courts' deference to board decisions can be summarized as follows:

(a) Promoting the value of entrepreneurial risk-taking and innovation;

(b) Recognizing as unreasonable a rule that otherwise would subject directors to liability when, with the benefit of 20/20 hindsight, their decisions may appear mistaken or unwise; and

(c) Upholding the board's managerial authority as centralized decisionmaker by preventing shareholder interference with this authority.

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40. Dooley, *supra* note 14, at 470; *see also* AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, Part IV (Duty of Care and the Business Judgment Rule), Introductory Note, at 135 (the special protection afforded business judgments is also based on a desire to limit litigation and judicial intrusiveness with respect to private-sector business decisionmaking); Spiegel v. Buntrock, 571 A.2d 767, 774 (Del. 1990) ("[T]he business judgment rule operates as a judicial acknowledgement of a board of directors' managerial prerogatives.").

41. Dooley, *supra* note 14, at 470 ("[A]ffording shareholders the right to demand frequent judicial review of board decisions has the effect of transferring decision-making authority from the board to the shareholders.").

42. *See Paramount*, 637 A.2d at 42 ("Under normal circumstances, neither the courts nor the stockholders should interfere with the managerial decisions of the directors."); Paramount Communications v. Time Inc., C.A. No. 10866, 1989 Del. Ch. LEXIS 77, at *89 (Del. Ch. July 14, revised July 17, 1989) ("The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm."), *aff'd*, 571 A.2d 1140 (Del. 1990).

43. Dooley & Veasey, *supra* note 32, at 521; *see also supra* notes 31-33 and accompanying text.

With this framework of deference in mind, it is appropriate to explore those instances in which the courts will override the board's authority and give priority to the value of accountability.

B. When the Value of Accountability Predominates: The Exacting Scrutiny of Entire Fairness

As we have seen, the business judgment rule reflects an assumption that investors benefit from a model of governance in which the board of directors has clear authority to manage the enterprise. Thus, there is thought to be "great social utility"[44] in encouraging directors (and the managers they hire to help formulate and implement corporate policy) to pursue their entrepreneurial vision efficiently, without the chilling threat that their decisions will be second-guessed by the courts. Given these perceived benefits, when does this model of deference succumb to the competing value of accountability to stockholders? As shown below, the value of accountability, or responsibility, is elevated—and that of deference diminished—when there is good reason to question the proper functioning of the board.

(1) The Entire Fairness Test

In the exercise of their power to manage the corporation, "directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders."[45] The "traditional hallmarks of a fiduciary" who undertakes to act on behalf of a corporation and its stockholders are the "[d]uty of care and duty of loyalty."[46] In its recent decision in *Cede & Co. v. Technicolor, Inc.*,[47] the Delaware Supreme Court emphasized that "[e]ach of these duties is of equal and independent significance."[48] Consequently, when a shareholder plaintiff provides evidence that the directors breached either or both of these duties,[49] the

44. Solash v. Telex Corp., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608, at 97,727 (Del. Ch. Jan. 19, 1988).

45. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993); *see also* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

46. *Cede*, 634 A.2d at 367; *see also Van Gorkom*, 488 A.2d at 872 (directors, being "vested with the responsibility for the management of the affairs of the corporation," must execute their duties "with the recognition that [they act] on behalf of others").

47. 634 A.2d 345 (Del. 1993).

48. *Id.* at 367.

49. Although the directors' duty of good faith was not identified in *Cede* as one of the "traditional hallmarks of a fiduciary," *id.*, it is plain from the decision that evidence of a breach of the director's basic duty to act in good faith would be independently sufficient to

evidentiary presumption of the business judgment rule (*i.e.*, the threshold presumption of propriety attaching to the directors' decision) is rebutted.[50] In that event, the "burden shifts to the defendant directors to prove . . . to the trier of fact the 'entire fairness' of the transaction to the shareholder plaintiff."[51]

Under this "entire fairness standard of judicial review,"[52] the defendant directors must demonstrate that the challenged transaction "was the product of both fair dealing *and* fair price."[53] In *Weinberger v. UOP, Inc.*,[54] the Delaware Supreme Court underscored the rigorous nature of this test by requiring the directors to establish "their utmost good faith and the most scrupulous inherent fairness of the bargain" in a manner "sufficient to pass the test of careful scrutiny by the court."[55]

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rebut the presumption of the business judgment rule. *See id.* at 361 ("To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the *triads* of their fiduciary duty—good faith, loyalty or due care.").

50. *Id.* at 361.

51. *Id.* (citing Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1989); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983)).

52. *Id.*; *see also* Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 111 (1979) (observing that the business judgment rule should not be available to directors who do "not exercise due care to ascertain the relevant and available facts before voting").

53. *Cede*, 634 A.2d at 361. In Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), the court elaborated on the analytical components of the entire fairness test and explained that the fair dealing and fair price aspects of the test must be examined in the overall context of the transaction and not as part of a bifurcated analysis:

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

Id. at 711 (citations omitted).

54. 457 A.2d 701 (Del. 1983).

55. *Id.* at 710. In its recent *Paramount* decision, the Delaware Supreme Court referred to the test of entire fairness as requiring "even more exacting scrutiny" than the intermediate level of judicial review involved in the enhanced scrutiny test. Paramount Communications v. QVC Network, 637 A.2d 34, 42 n.9 (Del. 1994).

(2) *Duty of Loyalty Concerns*

Delaware courts have long required that directors give precedence to "the best interest of the corporation and its shareholders . . . over any interest possessed by a director . . . ."[56] The court's classic formulation of this principle in *Guth v. Loft, Inc.*[57] continues to be cited regularly:

> A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty . . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self-interest.[58]

Thus, one "essential" prerequisite to the application of the business judgment rule "is the fact that there has been a business decision . . . by a disinterested and independent corporate decisionmaker."[59] If the evidence shows that "there is no independent corporate decisionmaker, the court may become the objective arbiter."[60]

The Delaware courts have generally defined a director as independent "only when the director's decision is based entirely on the corporate merits of the transaction and is not influenced by personal or extraneous considerations."[61] When a director receives a substan-

56. *Cede*, 634 A.2d at 361.

57. 5 A.2d 503 (Del. 1939).

58. *Id.* at 510, *cited in Cede*, 634 A.2d at 361; Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280, 1284 (Del. 1989); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); *Weinberger*, 457 A.2d at 710; *see also* Quillen, *The Federal-State Corporate Law Relationship—A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law*, 59 BROOK. L. REV. 107, 109 (1993) ("[T]he duty of loyalty rule as stated in the seminal Delaware case of *Guth v. Loft, Inc.* is still a guiding principle of Delaware corporate law today.") (footnote omitted).

59. *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993); Block et al., *supra* note 27, at 71 ("The protection afforded by the business judgment rule only shields corporate decisionmakers and their decisions from judicial second-guessing where, among other things, the decisionmakers are not subject to disqualifying conflicts of interest with respect to the subject matter of their decision.").

60. *Nixon*, 626 A.2d at 1376 (footnote omitted); *see also* AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) ("This unwillingness to assess the merits (or fairness) of business decisions of necessity ends when a transaction is one involving a predominately interested board with a financial interest in the transaction adverse to the corporation.").

61. *Cede*, 634 A.2d at 362.

tial benefit from voting to support a transaction, that director "cannot be objectively viewed as disinterested or independent."[62]

When such personal interests exist for a majority[63] of the directors, the law sensibly declines to accord deference to the business judgment of the board.[64] In the language of *Guth v. Loft*, the courts—given their knowledge "of human characteristics and motives"[65]—will assume under such circumstances that even highly-skilled business people may succumb to the temptation to pursue selfish ends at the potential expense of the stockholders.[66] The entire fairness test may

62. *Id.* (citing ERNEST L. FOLK, III, ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 141.2 at 141:33 (3d ed. 1992)). As the *Cede* court explained, "[c]lassic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally." *Id.*

63. For purposes of determining whether a board of directors is deemed interested or lacking in independence, the Delaware courts traditionally have required a showing of interest or lack of independence on the part of a majority of the directors. Paramount Communications v. QVC Network, 637 A.2d 34, 42 n.9 (Del. 1994); *Nixon*, 626 A.2d at 1370, 1375-76; Grobow v. Perot, 539 A.2d 180, 190 (Del. 1988); *AC Acquisitions*, 519 A.2d at 111; Aronson v. Lewis, 473 A.2d 805, 815 n.8 (Del. 1984). As Professor Dooley has succinctly observed:

> Where the board cannot claim a majority of disinterested members, Responsibility trumps Authority, and with good reason. If the board's decision was clouded with self-interest, there is no reason to assume that its action was intended to benefit the shareholders. Indeed, the contrary inference seems more likely, and there is no reason to preserve the authority of the board.

Dooley, *supra* note 14, at 487.

64. In *Aronson*, the Delaware Supreme Court took aim at critics who charge that Delaware law fails to account for the "structural bias" that is said to exist in the corporate boardroom:

> We recognize that drawing the line at a majority of the board may be an arguably arbitrary dividing point. Critics will charge that we are ignoring the structural bias common to corporate boards throughout America, as well as the other unseen socialization processes cutting against independent discussion and decisionmaking in the boardroom. The difficulty with structural bias in a demand futile case is simply one of establishing it in the complaint for purposes of Rule 23.1. We are satisfied that discretionary review by the Court of Chancery of complaints alleging specific facts pointing to bias on a particular board will be sufficient for determining demand futility.

473 A.2d at 815 n.8. In their scholarly commentary on this subject, Professor Dooley and former-practitioner Veasey read this discussion in *Aronson* as a clear rejection of the entire structural bias argument. *See* Dooley & Veasey, *supra* note 32, at 534 ("[T]he structural bias argument has no logical terminus. That perhaps explains why it was clearly rejected by the Delaware Supreme Court in *Aronson*.") (footnote omitted).

65. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

66. Dooley, *supra* note 14, at 487; *see also* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1284 (referring to "unyielding principle that corporate fiduciaries shall abjure every temptation for personal profit at the expense of those they serve"); *id.* at 1281 ("When presumably well-intentioned outside directors remove themselves from the design and execution of an auction, then what occurred here, given the human temptations left

be seen in this light as both a deterrent against managerial opportunism[67] and a statement that the trust placed in the board must be earned—and will not be assumed—when a majority of the directors has benefitted personally from a decision of its own making.[68]

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unchecked, was virtually inevitable."); Block et al., *supra* note 27, at 67 (explaining that deference is not accorded to decisions of interested fiduciaries "because of the danger such fiduciaries will make business decisions for their personal benefit and to the detriment of the corporation").

67. *See generally* John C. Coffee, Jr., *Contractual Freedom In Corporate Law: The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1620-24 (1989).

68. Block et al., *supra* note 27, at 77 ("The law regulates interest conflict transactions because experience shows that people may be injured."). Like most states, Delaware has a statutory procedure for preventing director conflicts from voiding corporate action. DEL. CODE ANN. tit. 8, § 144(a) (1991); *see also* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 365-66 (Del. 1993); Marciano v. Nakash, 535 A.2d 400, 403-05 (Del. 1987); Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976); R. FRANKLIN BALOTTI & J. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.9 at 4-207 *et seq.* (2d ed. Supp. 1993); FOLK, ET AL., *supra* note 62, at § 144:5; Block et al., *supra* note 27, at 78 ("The rationale underlying such statutes appears to be that business judgment rule protection is appropriate for an interested director or officer transaction where 'a fully informed majority of disinterested directors properly applies its business judgment in good faith to authorize the transaction.'") Dooley, *supra* note 14, at 488-90. Section 144(a) of the Delaware General Corporation Law "protects corporate actions from invalidation on grounds of director self-interest if such self-interest is: (1) disclosed to and approved by a majority of disinterested directors; (2) disclosed to and approved by the shareholders; or (3) the contract or transaction is found to be fair 'as to the corporation.'" *Cede*, 634 A.2d at 365 (quoting DEL. CODE ANN. tit. 8, § 144(a) (1991)).

An interesting question, which is beyond the scope of this Article, is whether a predominantly interested board can obtain business judgment rule protection under Section 144(a)(1) if the majority of interested directors disclose their personal interests to the disinterested minority and obtain their independent vote of approval for the transaction. *See, e.g., id.* at 366 n.34 ("[S]ection 144 removes the 'interested director cloud' from a transaction through three alternative methods and permits an otherwise interested transaction to be brought within the protection of the business judgment rule."); *Marciano*, 535 A.2d at 404-05 n.3 ("[A]pproval by fully informed disinterested directors under section 144(a)(1), or disinterested stockholders under section 144(a)(2), permits invocation of the business judgment rule."). On the other hand, such approval by the disinterested minority of directors might serve only the more limited purpose of immunizing the transaction against a challenge for voidness but not against judicial review for fairness. *See* § 144(a) ("No contract or transaction between a corporation and one or more of its directors . . . shall be void or voidable *solely* for this reason . . . .") (emphasis added); *Fliegler*, 361 A.2d at 222 (Section 144(a) "provides against invalidation of an agreement 'solely' because such a director or officer is involved. Nothing in the statute sanctions unfairness . . . or removes the transaction from judicial scrutiny."); *see also Marciano*, 535 A.2d at 404 ("The ratification process contemplated by section 144 presupposes the functioning of corporate constituencies capable of providing assents."); Eisenberg, *supra* note 34, at 454 (arguing for an intermediate standard of review of board approval of interested director transactions under section 5.02 of the ALI GOVERNANCE PROJECT); Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 10 (1993) ("[O]ne could debate whether or not a board committee could be sufficiently independent in this context to justify business judgment rule

(3) Duty of Care Concerns

Delaware law also requires that board action be the product of an informed and deliberative decision-making process. Thus, "[u]nder the business judgment rule there is no protection for directors who have made 'an unintelligent or unadvised judgment.'"[69]

To invoke the protection of the business judgment rule, "directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them."[70] Once the directors have become appropriately informed, "they must then act with requisite care in the discharge of their duties."[71] Over the years, the Delaware courts have established that the "concept of gross negligence" is the appropriate standard for determining whether a board's lack of information or care in making a decision is actionable.[72]

The Delaware Supreme Court "has consistently given equal weight to the [business judgment] rule's requirements of duty of care and duty of loyalty," both before and since *Van Gorkom*.[73] For example, in *Cede & Co. v. Technicolor, Inc.*,[74] the Delaware Supreme Court emphasized that evidence of a board's breach of its duty of care independently rebuts the presumption of the business judgment rule and triggers the scrutiny of the entire fairness test.[75]

review . . . ."); Claire M. Dickerson, *Interested Directors of New York Corporations and the Burden of Proof*, 1988 COLUM. BUS. L. REV. 91, 106-07 (1988) ("[I]f there are too few disinterested directors approving a transaction to satisfy the criteria of section 713 [New York's version of § 144], the business judgment rule will not prevent a review by the courts of the inherent fairness of the transaction . . . .") (footnote omitted); Dooley, *supra* note 14, at 489 (the "solely hedge" in section 144(a)(1) and comparable state statutes "might have been intended to preserve the right to obtain de novo judicial review of fairness, even after approval or ratification").

69. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Mitchell v. Highland-Western Glass Co., 167 A. 831, 833 (Del. Ch. 1933)).

70. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also Cede*, 634 A.2d at 367.

71. *Aronson*, 473 A.2d at 812.

72. *Van Gorkom*, 488 A.2d at 873; *Aronson*, 473 A.2d at 812.

73. *Cede*, 634 A.2d at 367.

74. 634 A.2d 345 (Del. 1993).

75. *Id.* at 361, 367 (adopting Chancery Court's presumed findings of gross negligence by defendant directors, reversing Chancery Court judgment in favor of directors and directing Chancery Court to apply entire fairness standard of review on remand); *see also Van Gorkom*, 488 A.2d at 873 (directing judgment in favor of shareholder plaintiffs in action where (i) "considerations of motive" were deemed "irrelevant" and (ii) directors were found to have breached their duty of care); *cf.* Sealy Mattress Co. v. Sealy, Inc., 532 A.2d 1324, 1337-38 (Del. Ch. 1987) (breach of directors' duty of care in parent-subsidiary merger supported determination that merger transaction failed to satisfy entire fairness test).

The Delaware courts' concern with the duty of care as an independently significant component of board action makes sense. It certainly makes little or no difference to shareholders whether their investment is affected adversely by a board's gross negligence or by acts of board disloyalty.[76] In either case, the essential fact is that investors may have sustained economic loss because the board's decision-making process has gone awry. Consequently, when a board's decision is likely the product of a dysfunctional process—in this context because there is evidence that the directors have been grossly negligent—the law quite sensibly displaces the model of deference with that of judicial scrutiny.

Courts do not defer to the directors' talent and vision when gross negligence is established because of the assumption that talent and vision will not overcome the likely flaws inherent in any decision reached with seriously deficient information or care. If in fact there are benefits worth preserving from such a decision, the law affords a mechanism to sustain them. Nevertheless, because confidence in the proper functioning of the decision-making body is lost, the courts will only uphold the board's action in this context if the directors can establish that the challenged transaction is entirely fair to the company's shareholders.[77]

(4) Summary

When talented people make decisions that are tainted by significant influences unrelated to the merits of the matter at hand—such as self-interest or demonstrably inadequate information or care—courts are far less interested in the skill and entrepreneurial vision of the decisionmakers than in the destabilizing influences that likely infected the decision-making process. The law assumes—reasonably, given its assumptions about human nature—that the hoped-for benefits of deference are remote in light of the potential mischief presented by a

76. Dooley, *supra* note 14, at 486 ("From an economic perspective, lapses in diligence are indistinguishable from lapses in fidelity: both are instances of self-interested behavior that reduce the value of the residual interest."). In *Macmillan*, the Delaware Supreme Court further demonstrated its concern for acts of director disloyalty that arise in an environment where outside directors fail to exercise appropriate oversight, especially with regard to transactions in which management directors are interested. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1264-65 (Del. 1989); *see also id.* at 1281 ("When presumably well-intentioned outside directors remove themselves from the design and execution of an auction, then what occurred here, given the human temptations left unchecked, was virtually inevitable.").

77. *Cede*, 634 A.2d at 367 (citing Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983); *Van Gorkom*, 488 A.2d at 873).

self-interested or uninformed decision. More is gained than lost in such circumstances when the law requires directors to account to the stockholders by establishing that their decision is deserving of the court's approval.

In short, a decision made by directors "under an influence which sterilizes their discretion"[78] may be sustained, but only if the directors can persuade the court that the challenged action of the board is entirely fair to the stockholders.[79] Courts will uphold and preserve the potential benefits of the managers' entrepreneurial vision in this context,[80] but they start with the sensible assumption that such benefits are nonexistent until the directors convincingly demonstrate otherwise.

II. Enhanced Scrutiny—The Early Years

The early 1980s witnessed a sharp increase in corporate takeover activity.[81] A number of federal courts in this era held that a target board's decision to adopt defensive measures in response to a hostile takeover bid was entitled to the protection of the business judgment rule.[82] In its 1984 decision in *Pogostin v. Rice*,[83] the Delaware Supreme Court ruled that the business judgment rule was equally ap-

78. Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).

79. *E.g.*, *Cede*, 634 A.2d at 361.

80. As Judge Winter has explained, the fairness analysis for self-dealing transactions is designed to preserve transactions which are beneficial to the corporation:

> To be sure, there is a risk of self-dealing that may damage the corporation, but such losses must be measured against the cost of prohibiting all such transactions including those that are beneficial. The rule evaluating self-dealing transactions by the standards of arms-length bargaining thus seeks to distinguish between beneficial and harmful transactions.

Ralph K. Winter, *On "Protecting The Ordinary Investor,"* 63 WASH. L. REV. 881, 893 (1988).

81. *See* Minstar Acquiring Corp. v. AMF Inc., 621 F. Supp. 1252, 1253 (S.D.N.Y. 1985) ("The recent years have seen a massive proliferation of corporate takeover battles."); Dennis J. Block & Yvette Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L.J. 44 (1983); Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 249 (1989); Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 274 (1983); Note, *Defensive Strategies and the Business Judgment Rule: Does Almost Anything Go in Delaware?*, 11 DEL. J. CORP. L. 535 (1986).

82. *See, e.g.*, Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757, 759 (2d Cir.), *cert. denied*, 464 U.S. 1018 (1983); Treadway Cos. v. Care Corp., 638 F.2d 357, 380-81 (2d Cir. 1980); Panter v. Marshall-Field & Co., 646 F.2d 271, 293-96 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 702-04 (2d Cir. 1980); *see also* Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981); William T. Quillen, *The Federal-State Corporate Law Relationship—A Response to*

plicable under Delaware law "in the context of a takeover."[84] The *Pogostin* court did not, however, specifically apply the rule to a board's use of defensive measures to thwart a takeover.[85] That analysis would come in "the watershed year of 1985 in Delaware jurisprudence,"[86] when the Delaware Supreme Court announced in *Unocal Corp. v. Mesa Petroleum Co.*[87] that directors are required to satisfy an "enhanced duty" in this context because of the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders . . . ."[88] The nature of the *Unocal* enhanced duty and its suspension of the "customary presumptions of the business judgment rule"[89] are discussed further below.

Within months of *Unocal*, the Delaware Supreme Court issued *Moran v. Household International, Inc.*,[90] a decision in which the court validated the "poison pill," an innovative defensive measure that empowers a board of directors to negotiate directly with a tender offeror on the stockholders' behalf and, in theory, to rebuff an unsolicited offer which the board concludes advisedly and in good faith is inadequate.[91] On the heels of *Moran* came *Revlon*, a decision which clari-

Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law, 59 BROOK. L. REV. 107, 110 (1993).

83. 480 A.2d 619 (Del. 1984).

84. *Id.* at 627.

85. The directors in *Pogostin* rejected an unsolicited tender offer but apparently took no steps to block the offer. 480 A.2d at 622, 627. *Pogostin* was used later in the decade to support the "just say no" defense—a moniker borrowed from the slogan for former First Lady Nancy Reagan's anti-drug campaign. Robert A. Prentice & John H. Langmore, *Hostile Tender Offers and the "Nancy Reagan Defense": May Target Boards "Just Say No"? Should They Be Allowed To?*, 15 DEL. J. CORP. L. 377, 382 (1990); *see, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1285 n.35 (Del. 1989) ("A refusal to entertain offers may comport with a valid exercise of business judgment.") (citing *Pogostin*, 480 A.2d at 627); Paramount Communications v. Time, Inc., 571 A.2d 1140, 1152 (Del. 1990) (same); *see also* Paramount Communications v. QVC Network, 637 A.2d 34, 43 n.13 (Del. 1994) ("[T]his Court has recognized the prerogative of a board of directors to resist a third party's unsolicited acquisition proposal or offer.") (citing *Pogostin*, 480 A.2d at 627).

86. E. Norman Veasey, Book Review, 15 DEL. J. CORP. L. 573, 576 (1990) (reviewing D. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS (3d ed. 1989)) [hereinafter, "Veasey, Book Review"].

87. 493 A.2d 946 (Del. 1985).

88. *Id.* at 954.

89. E. Norman Veasey, *Duty of Loyalty: The Criticality of the Counselor's Role*, 45 BUS. LAW. 2065, 2075 (1990) [hereinafter, "Veasey, *Duty of Loyalty*"].

90. 500 A.2d 1346 (Del. 1985).

91. *Id.* at 1354; Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180-81 (Del. 1986). A poison pill typically involves "a plan by which shareholders receive the right to be bought out by the corporation at a substantial premium on the occurrence of a stated triggering event." *Id.* at 180. It is the poison pill's threat of devastating eco-

fied that a board's narrowly focused obligation in the context of a sale of control is to obtain "the highest price for the benefit of the stockholders."[92] *Revlon* was not especially clear, however, on the standard of judicial review that applies to claims arising in the takeover setting (as opposed to *Unocal*'s antitakeover context).

Through the trilogy of *Unocal*, *Moran*, and *Revlon*, the Delaware Supreme Court laid the analytical foundation for a wave of fast-paced lawsuits that accompanied the accelerated takeover activity of the late 1980s.[93] Whenever the courts applied enhanced scrutiny to examine a

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nomic consequences to a hostile acquiror that empowers the target's directors (who retain the power to dismantle the device) to negotiate directly with any potential acquiror. *See, e.g.*, Facet Enterprises, Inc. v. Prospect Group, Inc., C.A. No. 9746, 1988 Del. Ch. LEXIS 51, at *9 (Del. Ch. Apr. 15, 1988) (noting advice of target board's legal counsel that poison pill would "increase the board's negotiating power with [the bidder] and allow it more time to develop, and explore financial alternatives"); Moran v. Household Int'l, Inc., 490 A.2d 1059, 1083 (Del. Ch.) ("Through its power to redeem the rights before a triggering event occurs the Household Board has assumed a plenary negotiating role."), *aff'd*, 500 A.2d 1346 (Del. 1985); MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1247 (Del. Ch. 1985) (explaining that, by adopting a poison pill, "[t]he Revlon Board thus assumed a great degree of responsibility by providing a substitute for the marketplace which ordinarily would judge the merits of Pantry Pride's, and any other potential acquiror's, tender offer"), *aff'd*, 506 A.2d 173 (Del. 1986).

It would be difficult to overstate the significance of the poison pill as a focal point in the takeover battles that erupted in the mid-to-late 1980s. *See* William T. Allen, *A Glimpse at the Struggle for Board Autonomy in American Corporation Law*, Remarks at Stanford Law School (Apr. 5, 1990), at 6 (characterizing the poison pill as a "most audaciously brilliant corporation law innovation"); DeMott, *supra* note 19, at 19 ("A pill, in effect, extends the time over which any given takeover contest will run, arguably enhancing the likelihood that higher offers will emerge."); Lyman Johnson, *Sovereignty Over Corporate Stock*, 16 Del. J. Corp. L. 485, 523 (1991) (the "upshot" of a board's deployment of a poison pill "is that purchases of large amounts of stock require the approval of a corporate board of directors as well as the decisions of individual shareholders") (footnote omitted); Martin Lipton, *Corporate Governance In the Age of Finance Corporatism*, 136 U. Pa. L. Rev. 1, 31 (1987) ("The rights plan . . . forces a raider to negotiate with the target's board to determine if it desires a second-step merger, and helps to ensure that the raider will not abuse the tender offer process."); Dale A. Oesterle, *Delaware's Takeover Statute: Of Chills, Pills, Standstills, and Who Gets Iced*, 13 Del. J. Corp. L. 879, 919 (1988) ("In essence, the goal of a poison pill plan is to create an event so onerous that no one can afford to trigger the plan with an unapproved acquisition, thus forcing all potential acquirors to seek the blessing of the existing board.") (footnote omitted); A.A. Sommer, Jr., *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 Del. J. Corp. L. 33, 34 (1991) ("The most unique of these [defensive] efforts, of course, was the 'poison pill,' more euphemistically known as 'shareholders' rights plans.'"); Charles M. Yablon, *Poison Pills And Litigation Uncertainty*, 1989 Duke L.J. 54, 61 ("Poison pills . . . give incumbent board members maximum flexibility to remove a pill's deterrent effects, if and when they decide to do so.").

92. 506 A.2d at 182.

93. *See generally* Gilson & Kraakman, *supra* note 81, at 251-54; Veasey, *Duty of Loyalty*, *supra* note 89, at 2075 (referring to the increase in takeover activity during the late 1980s).

board's decision to adopt antitakeover measures, they invariably relied on *Unocal*'s "omnipresent specter"[94] rationale—*i.e.,* the suspicion that directors who try to block a takeover *might* be acting primarily out of an improper desire to perpetuate their control.[95] Significantly, however, the courts continued to apply a conventional business judgment rule analysis to "*Revlon*" claims arising from a board's approval of a sale or change of control.[96]

A. The Enhanced Business Judgment Rule

As discussed below, *Unocal* announced a new "intermediate standard of review"[97] to govern a board's adoption of defensive measures. In *Moran*, the court applied *Unocal*'s enhanced scrutiny test to uphold the validity of a poison pill.

(1) Unocal

In 1985 the board of directors of Unocal Corporation was confronted with an unsolicited tender offer by Mesa Petroleum Co. and its affiliates.[98] Mesa made "a two-tier 'front loaded' cash tender offer for . . . approximately 37% . . . of Unocal's outstanding stock at a price of $54 per share."[99] Upon receiving advice from their investment

94. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

95. *See infra* Part II.B.

96. In *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1287-88 (Del. 1989), the Delaware Supreme Court later criticized the Chancery Court's failure to apply enhanced scrutiny in takeover cases. *See infra* note 196.

97. Gilson & Kraakman, *supra* note 81, at 251. In AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986), Chancellor Allen suggested that *Unocal*'s "intermediate" standard of review was developed to provide the courts with more flexibility because a determination whether to apply the business judgment rule or an entire fairness analysis frequently is outcome determinative:

> Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation. Perhaps for that reason, the Delaware Supreme Court recognized in *Unocal Corp. v. Mesa Petroleum Co.*, Del. Supr., 493 A.2d 946 (1985), that where a board takes action designed to defeat a threatened change in control of the company, a more flexible, intermediate form of judicial review is appropriate.

Id. at 111, *quoted with approval in* Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993); *see also Macmillan*, 559 A.2d at 1279.

98. *Unocal*, 493 A.2d at 949. Mesa Petroleum was controlled by T. Boone Pickens, Jr., whom the court described as "a corporate raider with a national reputation as a 'greenmailer'") *Id.* at 956.

99. *Id.* at 949. Shares not tendered to Mesa would be exchanged in a second-step merger transaction for "junk bonds" purportedly worth $54 per share. *Id.* Regarding the coercive nature of such offers, the Delaware Supreme Court observed that "[i]t is now well

bankers that Mesa's proposal was inadequate, the Unocal board—comprised of a majority of outside directors—rejected Mesa's proposal and implemented a defensive "self-tender offer."[100] Significantly, Unocal's self-tender specifically denied Mesa, then a 13% stockholder of Unocal, any opportunity to participate.[101]

Mesa challenged the defensive self-tender as a breach of the directors' fiduciary duties to Mesa as a Unocal stockholder.[102] The Chancery Court preliminarily enjoined Unocal from proceeding with the self-tender, reasoning that the business judgment rule did not apply to a discriminatory exchange offer.[103] The Delaware Supreme Court reversed and upheld the Unocal board's action as a reasonable response to the coercive and financially inadequate Mesa tender offer.[104] In reaching its decision, the Delaware Supreme Court announced its innovative, two-pronged analysis for assessing the validity of a board's decision to implement antitakeover measures.

As a preliminary matter, the Delaware Supreme Court reaffirmed the principle that the protection of the business judgment rule is afforded to a board when addressing a pending takeover bid.[105] However, because of the "omnipresent specter that a board may be acting primarily in its own interests"[106] in resisting a takeover—and thus "*may*" have breached its duty of loyalty[107]—the court imposed an

recognized that such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction." *Id.* at 956.

100. *Id.* at 950. The directors authorized the self-tender offer "to provide the stockholders with a fairly priced alternative to the Mesa proposal." *Id.* Under the terms of the Unocal self-tender, as later amended, Mesa offered to exchange debt securities with an aggregate par value of $72 per share for 49% of Unocal's outstanding shares. *Id.* at 951.

101. *Id.* at 949, 951.

102. *Id.* at 952-53.

103. *Id.*

104. *Id.* at 958-59.

105. *Id.* at 954 (noting that a board's duty in addressing a pending takeover bid "is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment") (footnote omitted).

106. *Id.*

107. *Id.* (emphasis added). In formulating the two-part analysis of the enhanced scrutiny test, the court in *Unocal* cited the classic *Guth v. Loft* articulation of the duty of loyalty: "In the board's exercise of corporate power to forestall a takeover bid our analysis begins with the basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders." *Id.* at 955 (citing *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. Super. Ct. 1939). *See also* Dooley, *supra* note 14, at 518 ("[I]t is clear that the question of motive is the predominant influence that has shaped the Delaware approach to board resistance. It drives both the initial assignment of justification to directors and the substantive standards of the *Unocal* rule.").

enhanced duty upon directors in this context.[108] This duty triggers a two-part "judicial examination at the threshold" into the directors' actions.[109] Only if the directors satisfy both parts of this threshold review will they retain the protections of the business judgment rule.[110]

In light of the "inherent conflict" that directors are thought to face when confronting a pending takeover bid,[111] they first must show "that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."[112] However, the real significance of *Unocal* lay in

108. *Unocal*, 493 A.2d at 954. As authority for its conclusion that the directors might well act out of an improper (*i.e.*, selfish) motive in this context, the *Unocal* court relied on Bennett v. Propp, 187 A.2d 405 (Del. 1962). In *Bennett*, the Delaware Supreme Court concluded—based essentially on the authority of a law review note discussing the Chancery Court's decision in *Bennett* (*see infra* note 350)—that "directors are of necessity confronted with a conflict of interest, and an objective decision is difficult" when they cause the corporation to purchase its own shares "to remove a threat to corporate policy when a threat to control is involved." *Unocal*, 493 A.2d at 955 (quoting *Bennett*, 187 A.2d at 409). The *Unocal* court's reliance on *Bennett* to question the motives of a predominantly disinterested board in responding to a takeover bid is at least questionable. *See infra* note 350.

109. In his thoughtful discussion on *Unocal*, then-practitioner Veasey offered the following analysis of the two-part threshold test:

> The application of an "enhanced" business judgment rule in contests for corporate control, as developed in *Unocal* and its progeny, implicates primarily two concepts which depart from the traditional formulation of the rule and its rationale. The first is a threshold shifting in the burden of proof (or at least the burden of going forward with the evidence) requiring directors to show by their good faith and reasonable investigation that they reasonably perceived a threat to corporate policy and effectiveness. The second involves judicial review of the reasonableness or proportionality of the corporate action taken in response to a threatened takeover.

Veasey, Book Review, *supra* note 86, at 576.

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

111. *Compare id.* at 955 (noting the "inherent conflict" directors face in adopting defensive measures to forestall a takeover) *with* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986) (noting the "potential for conflict" among directors that *Unocal* addresses).

112. *Unocal*, 493 A.2d at 955 (citing Cheff v. Mathes, 199 A.2d 548, 544-55 (Del. 1964)). The directors satisfy this first prong of the *Unocal* analysis "'by showing good faith and reasonable investigation . . . .'" *Id.* at 955 (quoting *Cheff*, 199 A.2d at 555). The directors' proof in this regard is "materially enhanced" when the board approving the defensive measures is "comprised of a majority of outside independent directors . . . ." *Id.* at 955.

This first prong of the *Unocal* analysis is essentially a reformulation of what previously constituted the entire test under *Cheff* for assessing the validity of a defensive stock repurchase. *See Cheff*, 199 A.2d at 554-55. As Professors Gilson and Kraakman observed in their thoughtful commentary on this subject: "*Cheff* framed a policy conflict/primary purpose test under which management's motives set the standard of review for defensive tactics. If a target's directors could demonstrate disagreement over corporate policy with a would-be acquiror, they were *presumed* to act from business considerations rather than self-interest." Gilson & Kraakman, *supra* note 81, at 249; *see also id.* at 251.

"the element of balance" required by the second prong of the enhanced scrutiny test. Under this second step, the court reviews the reasonableness of a board's defensive response to ensure that it is proportionate to the threat posed by the takeover bid.[113]

Because of the "'omnipresent specter' of director interest in maintaining control,"[114] there was a defensible rationale for according less deference than usual to Unocal's directors. On the other hand, because no actual self-interest was demonstrated, there was no reason to apply the entire fairness test.[115] Consequently, once the board satisfied *Unocal*'s threshold test—and thereby removed the suspicions about motives that arise when directors resist a takeover—it earned the protection of the business judgment rule.[116] The reasonableness or proportionality prong thus can be seen as providing a check on directors' motives while avoiding the necessity of a finding on this elusive issue.[117]

113. *Unocal*, 493 A.2d at 955 (before a defensive measure may "come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed"). *Compare* Gilson & Kraakman, *supra* note 81, at 251 ("The proportionality test brings a novel, objective standard to the review of defensive tactics—a reasonableness test that impliedly allows courts to identify and reject unreasonable tactics, whatever the motives of their authors.") *and* Veasey, Book Review, *supra* note 86, at 576 (noting *Unocal*'s "remarkable development" in requiring "judicial review of the reasonableness or proportionality of the corporate action taken in response to a threatened takeover") *with* Johnson & Siegel, *supra* note 24, at 330 (criticizing scrutiny under *Unocal* as "a toothless standard" that is "fairly inconsequential and far less stringent than a fairness test").

114. Veasey, *Duty of Loyalty*, *supra* note 89, at 2075 (quoting *Unocal*, 493 A.2d at 954).

115. Then-practitioner Veasey offered the following explanation of *Unocal*'s intermediate level of judicial review:

> The "enhanced" business judgment rule with its proportionality test is not a finding that in such cases there is necessarily a violation of the duty of loyalty. Accordingly, *Unocal* does not necessarily implicate court review for entire fairness, unless it is determined that the business judgment rule does not apply.

Veasey, *Duty of Loyalty*, *supra* note 89, at 2075; *see also* Paramount Communications v. QVC Network, 637 A.2d 34, 42 n.9 (Del. 1994) ("Where *actual self-interest* is present and affects a majority of the directors approving a transaction, a court will apply even more exacting scrutiny to determine whether the transaction is entirely fair to stockholders.") (emphasis added).

116. *Unocal*, 493 A.2d at 958.

117. *See* Dooley, *supra* note 14, at 521 (suggesting that "the *Unocal* 'reasonableness' test is intended to function as a filter for conflicted interest, rather than as an objective measure of whether the board's action was reasonably calculated to maximize shareholder wealth"); Lowenstein, *supra* note 81, at 314 (criticizing the pre-*Unocal* "primary purpose test" as too easily evaded by the skillful planning of a target's advisors); Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964); Bennett v. Propp, 187 A.2d 405, 408 (Del. 1962); Martin v. American Potash & Chem. Corp., 92 A.2d 295, 302 (Del. 1952); Kaplan v. Goldsamt, 380 A.2d 556, 568-69 (Del. Ch. 1977); Kors v. Carey, 158 A.2d 136, 140-41 (Del. Ch. 1960).

(2) Moran

The Delaware Supreme Court's decision in *Moran v. Household International, Inc.*[118] is noteworthy more for its validation of the poison pill defense than for its cryptic application of the principles announced months earlier in *Unocal.* In 1984, Household International, Inc.'s board—consisting of a majority of outside directors—adopted a poison pill because of general concerns about "the threat in the market place of coercive two-tier tender offers."[119] John Moran, one of Household's own directors, filed a lawsuit challenging the validity of the poison pill.[120] In affirming the Chancery Court's judgment in favor of Household, the Delaware Supreme Court applied *Unocal*'s two-prong threshold test and concluded, with little elaboration, that the poison pill "was a reasonable defensive mechanism to protect" Household from the threat of "coercive acquisition techniques."[121]

B. The *Revlon* Duty

In its landmark decision in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[122] the Delaware Supreme Court further developed its analysis of the enhanced duties of directors who resist a hostile takeover. The court also clarified directors' special responsibilities when they authorize a sale or break-up of the company.[123] As discussed below, in both aspects of the *Revlon* court's analysis—the use of de-

118. 500 A.2d 1346 (Del. 1985).

119. *Id.* at 1348, 1356. Although Household was not then faced with any specific takeover threat, the board nevertheless "was concerned about the increasing frequency of 'bust-up' takeovers." *Id.* at 1349 (footnote omitted).

120. Under the terms of the Household "Rights Plan," like any other poison pill, the board could redeem the rights for minimal consideration and thereby eliminate the poison pill as an obstacle to any offer it deemed adequate. *Id.* at 1349; *see also* Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180-81 (Del. 1986).

121. *Moran*, 500 A.2d at 1356-57. The court emphasized elsewhere in its opinion that the board could not use the poison pill "to arbitrarily reject" any tender offer:

> There is little change in the governance structure as a result of the adoption of the Rights Plan. The Board does not now have unfettered discretion in refusing to redeem the Rights. The Board has no more discretion in refusing to redeem the Rights than it does in enacting any defensive mechanism.

Id. at 1354. Professors Gilson and Kraakman criticized what they regarded as the absence of any meaningful analysis of the proportionality element of the second prong of the enhanced scrutiny test in either *Moran* or *Unocal.* Gilson & Kraakman, *supra* note 81, at 252.

122. 506 A.2d 173 (Del. 1986).

123. *Id.* at 182. The court left uncertain, however, the standard of judicial review for claims attacking a board's conduct in this setting. *See infra* note 149.

fensive measures and the conduct of an auction for corporate control—the dominant theme was director loyalty.

In 1985, Revlon rebuffed Pantry Pride, Inc.'s overtures for a friendly acquisition and adopted a poison pill.[124] After Pantry Pride commenced a hostile tender offer, Revlon initiated and then consummated a defensive self-tender offer for 10 million of Revlon's nearly 30 million outstanding shares in exchange for a combined package of senior subordinated notes (the "Notes") and other consideration.[125]

Pantry Pride responded with a new tender offer but was again rebuffed.[126] Revlon's board then authorized management to negotiate with other parties interested in acquiring the company, a step which effectively precipitated an auction for control of Revlon between Forstmann Little & Co. ("Forstmann"), a friendly bidder favored by Revlon management, and Pantry Pride.[127] Meanwhile, the trading value of the newly issued Notes dropped sharply when the Revlon board announced its intention to sell the company to Forstmann in a highly leveraged transaction.[128]

Although on notice that Pantry Pride would top any bid by Forstmann, the Revlon board agreed to an acquisition by Forstmann at $57.25 per share.[129] Revlon also granted concessions to Forstmann that effectively ended the auction including, significantly, an asset lock-up option on two major divisions of Revlon.[130] As part of the

124. *Id.* at 176-77.

125. *Id.* at 177. Under the terms of the Revlon exchange offer, each share of common stock accepted would be exchanged for one Senior Subordinated Note of $47.50 principal amount and one-tenth of a share of $9.00 Cumulative Convertible Exchangeable Preferred Stock valued at $100 per share. *Id.* This package thus "was thought to produce a security having a face value of $57.50 per share." MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1248 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986). In the aggregate, the Notes represented some $475 million of newly incurred Revlon debt. *Revlon*, 506 A.2d at 177-78.

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

127. *Id.* at 177-78.

128. *Id.* at 178. Irate over these developments, numerous Noteholders threatened litigation against the company. *Id.*

129. *Id.* at 178-79. Forstmann's $57.25 per share offer was actually worth somewhat less than its stated face amount when (i) discounted for the delays that the Forstmann transaction required and (ii) compared to Pantry Pride's immediately available $56.25 per share offer. *Id.* at 178 n.6. Pantry Pride subsequently raised its bid to $58 per share. *Id.* at 181.

130. Under the lock-up, Revlon granted Forstmann an option—exercisable in the event another acquiror obtained 40% of Revlon's shares—to purchase Revlon's Vision Care and National Health Laboratories divisions for $525 million, some $100-$175 million less than the value ascribed to these assets by Revlon's financial advisor, Lazard Freres. *Id.* at 178.

deal, Forstmann agreed to support the value of the Notes (which had continued to fall in the market) by an exchange of new notes.[131]

The Delaware Chancery Court preliminarily enjoined enforcement of (i) the lock-up option, (ii) a "no-shop" provision (that obligated Revlon to deal exclusively with Forstmann), and (iii) a cancellation fee agreement (that required Revlon to pay $25 million to Forstmann if their transaction was not completed).[132] The Chancery Court concluded that, by making concessions to Forstmann out of concern for their personal liability to the Noteholders, rather than maximizing the sale price of the company for the benefit of the stockholders, the Revlon directors had breached their duty of loyalty.[133] The Delaware Supreme Court affirmed, reasoning that the Revlon directors "breached their primary duty of loyalty" by entering "into an auction-ending lock-up agreement with Forstmann on the basis of impermissible considerations at the expense of the shareholders . . . ."[134]

(1) Enhanced Scrutiny for Defensive Measures

Before specifically addressing the duties of directors in the auction context, the *Revlon* court first examined the company's pre-auction takeover defenses within the framework of *Unocal*'s enhanced scrutiny analysis. As it had done in *Unocal*, the court emphasized the "omnipresent specter" of director self-interest that arises "when a board implements anti-takeover measures . . . ."[135] The court reasoned that this inherent potential for conflict justifies placing the burden on the directors to satisfy *Unocal*'s threshold examination before receiving the protection of the business judgment rule.[136] The court's formulation of the enhanced scrutiny test for the antitakeover measures in *Revlon* thus reemphasized the concern for director loyalty that justified diminished deference in *Unocal*.[137] The court concluded that

131. *Id.* at 179.

132. *Id.* at 175, 179.

133. MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1250 (Del. Ch. 1985); *see also Revlon*, 506 A.2d at 179.

134. *Revlon*, 506 A.2d at 182; *but see id.* at 185 (noting that the Revlon board's approval of the asset option lock-up was based on "considerations other than the maximization of shareholder profit" and also represented "a breach of the directors' fundamental duty of care").

135. *Id.* at 180 (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)).

136. *Id. Accord* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987) (describing the "potential for conflict" that arises "[w]hen directors oppose a hostile takeover").

137. The *Revlon* court described the two-part *Unocal* test as follows:

the Revlon board's defensive measures—the poison pill and the exchange offer—were proportionate, and therefore valid, responses to the threat posed by Pantry Pride's earlier inadequate takeover proposals.[138]

(2) *Auction Duties*

Revlon's principal significance lay in its explanation of the duties of directors who oversee the sale or break-up of a corporation.[139] The court emphasized that a board's responsibility changes dramatically in this context and requires the directors to focus narrowly on their obligation to obtain the best price for the stockholders:

> The Revlon board's authorization permitting management to negotiate a merger or buy out with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.[140]

The *Revlon* court concluded that the directors "breached their primary duty of loyalty" by acceding to Forstmann's demand for the lock-up agreement "on the basis of impermissible considerations," namely "shoring up the sagging market value of the Notes in the face of threatened litigation by their holders."[141] The court thus empha-

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> This potential for conflict places upon the directors the burden of proving that they had reasonable grounds for believing there was a danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation. In addition, the directors must analyze the nature of the takeover and its effect on the corporation in order to ensure balance—that the responsive action taken is reasonable in relation to the threat posed.

Revlon, 506 A.2d at 180 (citations omitted).

138. *Id.* at 180-81.

139. *Revlon* also marked the first occasion in which the Delaware Supreme Court explicitly described the intermediate level of review under *Unocal* as a test of "enhanced scrutiny." *Id.* at 184. *Cf. Unocal*, 493 A.2d at 954 (referring to an "enhanced duty which calls for judicial examination at the threshold").

140. *Revlon*, 506 A.2d at 182; *see also* Johnson & Siegel, *supra* note 24, at 341 ("*Revlon* not only requires directors to maximize price once the company is for sale but also makes clear that the directors' sole responsibility is to find a price that benefits their shareholders.").

141. *Revlon*, 506 A.2d at 182. The court reasoned further that the Revlon board's "focus" on securing a deal with an acquiror committed to solving the Notes problem "was

sized that the board's concern for nonshareholder constituencies (like the Noteholders) was inappropriate in the context of a sale of the company.[142] The court likewise affirmed the Chancery Court's order barring enforcement of the no-shop and cancellation fee agreements because these provisions also violated the board's primary duty as "an auctioneer responsible for selling the company to the highest bidder."[143]

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inconsistent with the changed concept of the directors' responsibilities at this stage of the developments." *Id.*

142. *Id.* A board's consideration of the interests of nonstockholder constituencies in the context of a takeover has been the subject of extensive judicial commentary. The *Unocal* court observed that in responding to an unsolicited bid, a board could consider the "impact" of the offer "on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally) . . . ." *Unocal*, 493 A.2d at 955. In *Revlon*, the court clarified that a board's regard for the interests of such constituencies (i) is limited by the general requirement that there be "rationally related benefits accruing to the stockholders" and (ii) is inappropriate once an auction is under way and the board's objective is not to protect the corporate enterprise "but to sell it to the highest bidder." *Revlon*, 506 A.2d at 182. *See also* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1282 n.29 ("[A] board may consider . . . the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests . . . ."); *id.* at 1285 n.35 (permitting consideration of (i) "the various constituencies, particularly the stockholders" and (ii) "any special factors bearing on stockholder and public interests").

The concern for nonstockholder constituencies has also sparked considerable scholarly debate. *Compare* Lipton, *supra* note 91, at 43 n.193 (asserting that shareholder wealth is enhanced by a concern for non-shareholder constituencies because "[a] corporation's relationships with its employees, customers, and suppliers . . . are heavily dependent on its ability to foster good will with these groups") *and* Theodore N. Mirvis & Andrew R. Brownstein, *Stock-For-Stock Business Combinations and Directors' Responsibilities*, 14 INST. ON ACQUISITIONS & TAKEOVERS 1, 19-20 (1994) ("In stock mergers not involving a change in control . . . the directors should appropriately take into account the impact of the prospective transaction on the company, its employees, its customers and the community in which it operates.") *and* John C. Coffee, Jr., *Opinion*, 1 MERGERS & ACQUISITIONS L. REP. 981, 984-85 (1989) (commenting on *Unocal* and the proposition that a board's assessment of the "threat posed" by a hostile offer may entail consideration of the offer's impact on nonstockholder constituencies); *with* Sommer, *supra* note 142, at 55-56 (arguing that state constituency statutes, which permit directors to consider nonstockholder interests, should be construed in keeping with Delaware precedent so that directors may consider interests of such other constituencies only "if that consideration is consistent with shareholder welfare") *and* Allen, *supra* note 91, at 22-25 (suggesting that state constituency statutes "may have long-run implications for the efficiency of our economy") *and* Christopher J. Smart, *Takeover Dangers and Non-Shareholders: Who Should Be Our Brothers' Keeper?*, 1988 COLUM. BUS. L. REV. 301, 330 (1988) (criticizing the antitakeover policy of state constituency statutes because "[t]arget directors are well-suited to maximizing returns on invested capital, but not to protecting non-shareholders from the dangers of takeover activity").

143. *Revlon*, 506 A.2d at 184. In this regard, the *Revlon* court emphasized that the "directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions" when "bidders make relatively similar offers . . . ." *Id.* The court also

Although the *Revlon* court alluded to *Unocal* in its analysis of the directors' duties in the context of an auction,[144] the court's invalidation of the lock-up option rested principally, if not entirely, on the court's conclusion that the Revlon directors "breached their primary duty of loyalty."[145] Because the evidence showed that Revlon's directors had breached their fiduciary duties in this regard, their decision to grant the asset lock-up to Forstmann was not entitled to deference under the business judgment rule.[146]

(3) Summary

The court's enhanced scrutiny of the Revlon board's defensive measures was justified by its concern with the effect of *potential* director disloyalty on the board's decision-making process. The Revlon directors satisfied the *Unocal* test for these defensive measures and thereby dispelled any suspicions about their motives.[147]

On the other hand, regarding the sale of the company, the evidence showed that Revlon's directors improperly favored Forstmann over Pantry Pride for selfish reasons (avoiding liability to Noteholders) instead of resolutely pursuing the highest available price for the shareholders. Consequently, because evidence of disloyalty demon-

explained that "[m]arket forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity." *Id.* (footnote omitted).

144. *See, e.g., id.* at 183 ("We must conclude that the merger agreement with Forstmann was unreasonable in relation to the threat posed."); *id.* at 184 ("[W]hen 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 . . . the action cannot withstand the enhanced scrutiny which *Unocal* requires of director conduct."); *id.* ("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.").

145. *Id.* at 184. *See also In re* J.P. Stevens & Co. Shareholders Litig., 542 A.2d 770, 781 (Del. Ch. 1988) (referring to *Revlon* as "a breach of loyalty case (*i.e.*, one in which the board appeared not to be acting in good faith for the shareholders' benefit)"); Gilson & Kraakman, *supra* note 81, at 252-53 ("The *Revlon* case, moreover, may be consistent with this minimalist construction [of *Unocal*'s proportionality test] insofar as it pointedly invokes the directors' duty of loyalty in lieu of a proportionality argument when it enjoins management's defensive lock-up option.").

146. *Revlon*, 506 A.2d at 182, 185; *see also* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 274-75 (2d Cir. 1986) (invalidating decision of target corporation's board to grant asset lockup option to management-affiliated leveraged buy-out group where target board was found to have breached its duty of care); Stephen P. Lamb & Andrew J. Turezyn, Revlon *and* Hanson Trust: *Unlocking the Lock-Ups*, 12 Del. J. Corp. L. 497 (1987); Kenneth J. Nachbar, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.—*The Requirement of a Level Playing Field in Contested Mergers, and Its Effect on Lock-Ups and Other Bidding Deterrents*, 12 Del. J. Corp. L. 473 (1987).

147. *Revlon*, 506 A.2d at 180.

strated that the Revlon board's decision-making process had functioned improperly in the auction, the directors were not accorded the deference of the business judgment rule.[148] Although *Revlon* thus clarified the obligations of directors in the sale of control context, the standard of judicial review for claims in this setting remained unclear.[149]

C. *Unocal* and *Revlon* Claims in the Late 1980s: A False Dichotomy?

During the three-year period after *Revlon* was decided, the courts applied *Unocal* with great frequency to assess the validity of various defensive measures. In each case, the premise for applying enhanced scrutiny was *Unocal*'s "omnipresent specter" of potential director disloyalty.

Meanwhile, the Chancery Court continued to work out its unsettled role with regard to a board's decisions in the context of an auction. One might logically have assumed that suspicions about director loyalty in the antitakeover setting would not arise when a board was in the "*Revlon* mode."[150] Indeed, some early Chancery Court decisions involving *Revlon* claims implied this.[151] An analytical dichotomy thus emerged during this era in which the courts applied *Unocal*'s enhanced scrutiny to review defensive measures but applied the traditional business judgment rule to board decisions in the context of a sale or change of control.

(1) Unocal *Claims*

In the late 1980s, the courts consistently cited directors' "potential for conflict"[152] as justification for assessing the reasonableness of boards' decisions in resisting a takeover. In *Polk v. Good*,[153] for example, the Delaware Supreme Court cited this "potential conflict of

148. *Id.* at 185.

149. As discussed *infra*, at Part III, it was not until the Delaware Supreme Court's *Macmillan* decision in 1989 that the court explicitly announced that the enhanced scrutiny test of *Unocal* also would apply, albeit in modified form, to director conduct in an auction for control of a corporation. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287-88 (Del. 1989).

150. Paramount Communications v. Time, Inc., C.A. No. 10866, 1989 Del. Ch. LEXIS 77, *67 (Del. Ch. July 14, revised July 17, 1989), *reprinted in* 15 Del. J. Corp. L. 700, 738 (1990) (using "*Revlon* mode" as a shorthand description for a board's obligation to pursue the best price for shareholders when a sale or break-up is inevitable), *aff'd*, 571 A.2d 1140 (Del. 1990).

151. *See infra* notes 165-182 and accompanying text.

152. *Revlon*, 506 A.2d at 180.

153. 507 A.2d 531 (Del. 1986).

interest" in applying a *Unocal* analysis to uphold the Chancery Court's approval of a derivative and class action settlement involving a defensive repurchase of shares by Texaco, Inc.[154] In *Ivanhoe Partners v. Newmont Mining Corp.*,[155] the Delaware Supreme Court, again referring to the "potential for conflict," upheld a defensive restructuring transaction.[156]

The Delaware Court of Chancery also consistently relied on the "potential conflict" rationale in according diminished deference to the decisions of various boards resisting threatened takeovers. In *AC Acquisitions Corp. v. Anderson, Clayton & Co.*,[157] for example, the court preliminarily enjoined Anderson, Clayton & Co. from pursuing a coercive self-tender offer that unreasonably precluded the company's shareholders from choosing an unsolicited all-cash, all-shares offer by Bear Stearns & Co., Inc.[158] The Chancellor emphasized that *Unocal*'s enhanced scrutiny test responds to the concern that a board "*may*" be acting out of self-interest in this context:

> [T]he Delaware Supreme Court recognized in *Unocal* . . . that where a board takes action designed to defeat a threatened change in control of the company, a more flexible, intermediate form of judicial review is appropriate. In such a setting the "omnipresent specter that a board *may* be acting primarily in its own interests," 493 A.2d at 954 (emphasis added), justifies the utilization of a standard that has two elements.[159]

154. *Id.* at 537. *Polk* was actually decided on March 10, 1986, three days before the Delaware Supreme Court issued its written opinion in *Revlon*.

155. 535 A.2d 1334 (Del. 1987).

156. *Id.* at 1341; *see also id.* at 1344 ("The Newmont board acted to maintain the company's independence and not merely to preserve its own control. . . . Thus, the Newmont directors have satisfied their burden under *Unocal*, and their actions are within the ambit of the business judgment rule."); Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227, 1239 (Del. Ch. 1988) (enjoining defensive restructuring transaction, the Chancery Court observed that "[w]here, as here, the transaction at issue develops in the context of a pending takeover bid, even a disinterested board of directors 'may be acting primarily in its own interests'") (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)).

157. 519 A.2d 103 (Del. Ch. 1986).

158. *Id.* at 108. The Chancellor's finding of unreasonableness may well have been prompted in part by the Anderson, Clayton board's surprisingly nonmanagerial assertions that (i) "the decision in this fundamentally economic contest lies properly with the shareholders"; and (ii) the board "has preserved the ability of the stockholders to choose between these two options." *Id.* at 112.

159. *Id.* at 111 (quoting *Unocal*, 493 A.2d at 954). Elsewhere in the opinion, the Chancellor again alluded to the elusive nature of director self-interest in this setting, observing that the entrenchment effect of the company's coercive self-tender "*creates a species of director interest even on the part of outside directors . . . .*" *Id.* at 115 (emphasis added); *see also* Veasey, *Duty of Loyalty*, *supra* note 89, at 2075 (the *Unocal* "proportionality test is not a finding that in such cases there is necessarily a violation of the duty of loyalty").

Numerous "poison pill" decisions in this period also relied, explicitly or implicitly, on *Unocal*'s "omnipresent specter" rationale.[160] In *City Capital Assocs. v. Interco, Inc.*,[161] the Chancellor invoked *Unocal* in holding that the Interco directors could not use a poison pill to protect a defensive restructuring transaction adopted in response to an unsolicited all-cash, all-shares tender offer.[162] In applying enhanced scrutiny, the *Interco* court opined that *Unocal* responds to the human frailties that can taint a board's decision-making process in the context of a threatened change of control:

> *Unocal* . . . recognized that in defending against unsolicited takeovers, there is an "omnipresent specter that a board may be acting primarily in its own interest . . . ." That fact distinguishes takeover defense measures from other acts of a board which, when subject to

160. *See, e.g.,* CRTF Corp. v. Federated Dep't Stores, Inc., 683 F. Supp. 422, 436-39 (S.D.N.Y. 1988) (upholding continued use of poison pill as a "gavel to run an auction," the court opined that the "enhanced duty" under *Unocal* is designed "[t]o deal with" the "inherent potential conflict of interests that exists when a Board is in the position of deciding whether and how to defend against a takeover attempt"); BNS, Inc. v. Koppers Co., 683 F. Supp. 458, 473 (D. Del. 1988) (upholding continued use of poison pill: "The presence of a hostile bidder strains the ability of a board of directors to act in the best interests of its shareholders, because of 'the omnipresent specter that a board may be acting primarily in its own interests . . . .'") (quoting *Unocal*, 493 A.2d at 954); Grand Metropolitan PLC v. Pillsbury Co., 558 A.2d 1049, 1055 (Del. Ch. 1988) (citing the "omnipresent specter of potential director self-interest" addressed by *Unocal* and enjoining continued use of a poison pill to block an all-cash, all-shares tender offer); *In re* Holly Farms Corp. Shareholders Litig., C.A. No. 10350, 1989 Del. Ch. LEXIS 71, at *29 (Del. Ch. Dec. 30, 1988) (enjoining effectuation of an auction-ending asset lock-up agreement, but upholding continued use of a poison pill defense upon finding that "it may still have a role in maximizing values"); MAI Basic Four, Inc. v. Prime Computer, Inc., C.A. No. 10428, 1988 Del. Ch. LEXIS 161, at *7, *12 (Del. Ch. Dec. 20, 1988) (citing "potential for conflict" addressed by *Unocal*'s enhanced scrutiny test and declining to order redemption of a poison pill given "the short time the tender offer ha[d] been pending"); Doskocil Cos. v. Griggy, C.A. No. 10095, 1988 Del. Ch. LEXIS 132, at *7, *13 (Del. Ch. Oct. 7, 1988) (refusing to redeem rights under a poison pill where evidence showed that an auction involving competing bidders had not concluded); Nomad Acquisition Corp. v. Damon Corp., C.A. No. 10173, 1988 Del. Ch. LEXIS 133, at *12, *15 (Del. Ch. Sept. 20, 1988) (citing the "higher duty" imposed on directors by *Unocal* in light of the "potential for conflict" in takeovers, but holding that the target board acted reasonably in refusing to redeem its poison pill for an unsolicited offer at an inadequate price); Tate & Lyle PLC v. Staley Continental, Inc., C.A. No. 9813, 1988 Del. Ch. LEXIS 61, *26 (Del. Ch. May 9, 1988) (citing *Unocal*, and refusing to enjoin a poison pill where (i) the target's shares in market price were trading higher than the tender offer price, and (ii) the poison pill was "serving a useful purpose in allowing the Board to seek a more realistic offer"); Facet Enters., Inc. v. Prospect Group, Inc., C.A. No. 9746, 1988 Del. Ch. LEXIS 51, at *19-21 (Del. Ch. Apr. 15, 1988) (citing *Moran*—which applied *Unocal* analysis—and refusing to order redemption of a poison pill where the target's board decided to conduct an auction and the pill would provide "a reasonable opportunity to conduct and complete the auction").

161. 551 A.2d 787 (Del. Ch. 1988).

162. *Id.* at 797-98.

> judicial review, are customarily upheld once the court finds the board acted in good faith and after an appropriate investigation .... *Unocal* recognizes that human nature may incline *even one acting in subjective good faith* to rationalize as right that which is merely personally beneficial. Thus, it created a new intermediate form of judicial review to be employed when a transaction is neither self-dealing nor wholly disinterested.[163]

In each of these decisions in which *Unocal* was applied, the courts provisionally suspended the customary deference of the business judgment rule to address the suspicion with which directors are viewed when they resist a takeover and preserve their control. In this same era, however, a board's decision to approve a takeover was not regarded as an occasion for such suspicion.

(2) Revlon *Claims*

Throughout 1988 and 1989, yet another "watershed" era[164] in Delaware takeover jurisprudence, the Court of Chancery issued a number of opinions resolving "*Revlon*" claims. Unlike the cases in this same era in which courts applied enhanced scrutiny to antitakeover measures, the Chancery Court employed a conventional business judgment rule analysis for cases involving a sale of control.

In *Solash v. Telex Corp.*,[165] for example, Chancellor Allen applied a business judgment analysis in upholding the decision by the directors of Telex Corporation to recommend an acquisition of the company by Memorex International, N.V.[166] In refusing to enjoin the Memorex offer, the Chancellor noted that the plaintiffs had failed to establish a reasonable probability of "overcoming the presumption of sound business judgment."[167] The court also rejected the plaintiffs' duty of loyalty claims because the evidence failed to show any conflicting economic or other personal interests among the directors,

163. *Id.* at 796 (citations omitted). In *Time-Warner*, the Delaware Supreme Court criticized the analyses in *Interco* and *Grand Metropolitan*—in which the courts reasoned that the only threat posed by an all-cash, all-shares tender offer is price inadequacy—as demonstrating an inappropriately "narrow and rigid construction of *Unocal*." Paramount Communications v. Time, Inc., 571 A.2d 1140, 1153 (Del. 1990). The court emphasized that the "usefulness of *Unocal* as an analytical tool is precisely its flexibility in the face of a variety of fact scenarios" and that the "open-ended analysis mandated by *Unocal* is not intended to lead to a simple mathematical exercise . . . ." *Id.*

164. Veasey, Book Review, *supra* note 86, at 578.

165. [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,608 (Del. Ch. Jan. 19, 1988).

166. *Id.* Interestingly, the *Telex* court suggested both the judicial competency and entrepreneurial risk-taking rationales for the traditional business judgment rule. *Id.* at 97,727; *see supra* notes 28-43 and accompanying text.

167. *Id.* at 97,728.

"*even if only in the somewhat diluted form present in every 'entrenchment' case.*"[168] Thus, the court in *Telex* implicitly accepted the proposition that the "potential for conflict" that justifies enhanced scrutiny in the *Unocal* context did not arise when directors approved a change-of-control transaction.[169]

In *In re J.P. Stevens & Co. Shareholders Litigation*,[170] the Chancery Court explicitly refused to conduct a *Unocal* reasonableness review in rejecting attacks on the board's decision to agree to a topping fee and break-up fee in an auction for control of J.P. Stevens & Co:[171]

> [T]his case involves neither a self-dealing transaction . . . nor corporate measures designed to defeat a threatened change in control . . . . Thus, I do not regard myself as authorized by *Unocal* or any other precedent of this court or the Supreme Court to pass upon the reasonableness of the judgment to grant the topping fee or the expense reimbursement provision . . . .[172]

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168. *Id.* at 97,727 (emphasis added).

169. *Id.* at 97,728; *see also id.* at 97,727 ("Where there is no adverse financial or personal interest such as an alleged entrenchment motivation or effect, that question unquestionably implicates not the directors' duty of loyalty, but the duty of care."). Similarly, in Yanow v. Scientific Leasing, Inc., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,660 (Del. Ch. Feb. 5, revised Feb. 8, 1988), the court appeared to rely on a business judgment rule analysis in rejecting a claim that the procedures employed in the sale of Scientific Leasing, Inc. ("SLI") violated *Revlon*'s requirements. *Id.* at 98,034. The *Yanow* court was especially dismissive of the plaintiffs' assertion that, in lieu of a "firesale" auction, the directors should have at least contacted all companies that previously had expressed an interest in SLI and invited them to submit bids: "The real dispute boils down to what specific methods corporate directors may use to elicit bids from potential acquirors. That issue would appear to be normally a matter of director judgment that necessarily must vary with each case." *Id.*

170. 542 A.2d 770 (Del. Ch. 1988).

171. One of the three competing bidders, West Pepperell, Inc., asserted that the J.P. Stevens board violated its *Revlon* duties by improperly favoring rival bidder Odyssey Partners with an agreement to cause J.P. Stevens to pay Odyssey a topping fee (up to $8 million) and a break-up or expense reimbursement fee ($17 million) in the event its $64 per share bid was surpassed by a rival bidder. *Id.* at 777, 781. The J.P. Stevens directors saw the agreement to pay Odyssey a topping fee as necessary to induce Odyssey to increase its bid from $61.50 per share to $64 per share under circumstances which nevertheless permitted rival bidders to acquire the company for a price in excess of $64 per share. *Id.* at 782.

172. *Id.* at 780 (citations omitted). Applying the business judgment rule, the court noted that its review of the directors' business decision was limited to assessing whether the decision was "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." *Id.* at 780-81 (footnote omitted). Elsewhere in its opinion, the Chancery Court, applying a classic business judgment rule analysis, declined to second-guess the reasonableness of the special committee's decision to commit to pay Odyssey the topping fee and break-up fee. *Id.* at 783 ("These are precisely the sort of debatable questions that are beyond the expertise of courts and which the business judgment rule generally protects from substantive review for wisdom.").

If *J.P. Stevens* were decided today, the directors would be required under *Macmillan* and *Paramount* to demonstrate the reasonableness of the topping fee and break-up fee

The topping fee and break-up fee thus were sustained under a conventional business judgment rule analysis because the directors' decisions to grant these concessions to Odyssey were "not so far afield" as to warrant an inference of inappropriate motive.[173]

The Chancery Court again applied a business judgment rule analysis in rejecting *Revlon* claims in *In re RJR Nabisco, Inc. Shareholders Litigation*.[174] This decision arose out of an auction for control of RJR Nabisco, Inc., which, after successive rounds of competitive bidding, became a battle between the investment firm of Kohlberg Kravis Roberts & Co. ("KKR") and a management buy-out group that included F. Ross Johnson (RJR's President and CEO) and two prominent investment banking firms (the "Management Group").[175] The eventual purchase price paid by KKR was $25 billion, making RJR Nabisco the largest takeover in history.[176]

Certain RJR shareholders sought to enjoin the KKR tender offer extended pursuant to the merger agreement.[177] Among other things, the shareholder plaintiffs argued that (i) the "auction was cut short

provisions—both instances of disparate treatment of bidders purportedly for the benefit of shareholders—in the context of enhanced scrutiny. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287-88 (Del. 1989); Paramount Communications v. QVC Network, 637 A.2d 34, 45 (Del. 1994).

173. *J.P. Stevens*, 542 A.2d at 783. Chancellor Allen also applied a traditional business judgment rule analysis to dispose of the shareholders' *Revlon* claim in Citron v. Fairchild Camera & Instrument Corp., C.A. No. 6085, 1988 Del. Ch. LEXIS 67 (Del. Ch. May 19, 1988), *aff'd*, 569 A.2d 53 (Del. 1989):

> [P]laintiff is certainly incorrect to assert that [*Revlon*] recognized a duty on the part of directors when a corporation is "for sale," to get the highest available price. Rather, the duty can only be to try in good faith, in such a setting, to get the best available transaction for the shareholders. Directors are not insurers.

Id. at *50. *See also In re* Fort Howard Corp. Shareholders Litig., C.A. No. 9991, Del. Ch. LEXIS 110, at *37-39 (Del. Ch. Aug. 8, 1988) (applying "business judgment form of judicial review," the court rejected a *Revlon* challenge to a management-led buy-out where the board conducted a "market check" in lieu of an auction); *In re* Holly Farms Corp. Shareholders Litig., C.A. No. 10350, 1989 Del. Ch. LEXIS 71, at *17 (Del. Ch. Dec. 30, 1988) (applying what appeared to be a traditional business judgment analysis in enjoining an asset lock-up option and other measures that improperly foreclosed competitive bidding). *But see id.* at *15 ("The Board, therefore, failed to act rationally to meet the high standards articulated in *Revlon*."); *id.* at *11 ("'*Revlon* . . . requires that there must be the most scrupulous adherence to ordinary principles of fairness in the conduct of an auction for the sale of a corporate enterprise'") (quoting Mills Acquisition Co. v. Macmillan, Inc., Nos. 415 & 416, 1988 (Del. Nov. 2, 1988) (bench ruling)).

174. No. 10389, 1989 Del. Ch. LEXIS 9, at *38-40, *46-47, *56-58 (Del. Ch. Jan. 31, amended Feb. 14, 1989), *appeal refused*, 556 A.2d 1070 (Del. 1989).

175. *Id.* at *2.

176. *Id.* at *3; DeMott, *supra* note 19, at 1.

177. *RJR Nabisco*, 1989 Del. Ch. LEXIS 9, at *1-2.

with 'substantially equivalent' bids on the table,"[178] and (ii) the RJR directors breached their *Revlon* duties by conducting an ineffective auction.[179] In refusing to enjoin the transaction, the court specifically rejected the proposition that the decisions of an informed, disinterested, and appropriately motivated board nevertheless can be set aside under *Revlon* if the auction somehow achieves a less favorable price than might otherwise have been obtained.[180] The court reasoned that such an interpretation of *Revlon* would improperly require judicial review of the substance of a board's auction decisions.[181]

178. *Id.* at *8. In recommending the KKR deal, the special committee of directors that evaluated the bids perceived a risk that an attempt to engage in further negotiations with either the Management Group or KKR might result in the withdrawal of either party from the bidding process. *Id.* at *33. The KKR deal was also seen, among other things, as offering shareholders greater equity participation in the acquired company. *Id.*

179. *Id.* at *9.

180. *Id.* at *61. The court thus observed:

> I take it to be the case, ordinarily, that such substantive review of the business decision with these characteristics is unauthorized. The claim is that the *Revlon* case establishes an exception to the business judgment form of judicial review in the context of a "sale" of a corporation. In this setting, it is claimed that even a fully independent board has a duty, distinct from its omnipresent duty, to act in good faith and with due care, to conduct a fair (or alternatively an effective) "auction." Thus, that case is said to create distinctive "*Revlon* duties" that exist not as a subset of traditional duties of loyalty and care but independently. Under this view, if on a *post hoc* review an auction is said to be unfair . . . or ineffective or "unauction-like" in some material respect, the results may be set aside even if no breach of directorial duty of care or loyalty is involved. This is an interpretation of *Revlon* that I do not share.

Id.

181. *Id.* The court recognized, however, that the Delaware Supreme Court's November 1988 bench ruling in *Macmillan* suggested a potentially more probing level of judicial review. *See id.* at *64 (questioning whether the *Macmillan* bench ruling suggests "traditional business judgment analysis or refer[s] to an independent, *post hoc* judicial evaluation of fairness or effectiveness of the auction apart from the good faith of directors and officers") (citing Mills Acquisition Co. v. Macmillan, Inc., Nos. 415 & 416, 1988 (Del. Nov. 2, 1988) (bench ruling)). Some three months after the Chancellor's decision in *RJR Nabisco*, the Delaware Supreme Court issued its full opinion in *Macmillan* which included, among other things, a criticism of the Chancery Court's use of an "ordinary business judgment rule analysis" in *RJR Nabisco* and other decisions discussed above. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287-88 (Del. 1989) (criticizing *In re* RJR Nabisco, Inc. Shareholders Litig., C.A. No. 10389, 1989 Del. Ch. LEXIS 9 (Del. Ch. Jan. 31, amended Feb. 14, 1989); *In re* Holly Farms Corp. Shareholders Litig., C.A. No. 10350, 1989 Del. Ch. LEXIS 71 (Del. Ch. Dec. 30, 1988); *In re* Fort Howard Corp. Shareholders Litig., C.A. No. 9991, 1988 Del. Ch. LEXIS 110 (Del. Ch. Aug. 8, 1988); *In re* J.P. Stevens & Co. Shareholders Litig., 542 A.2d 770 (Del. Ch. 1988)).

(3) Summary

The surge of takeover activity in the late 1980s afforded numerous opportunities to apply *Unocal*'s enhanced scrutiny test. In resolving challenges to various antitakeover measures, the courts routinely invoked *Unocal*'s "omnipresent specter" of director self-interest—later clarified as a "potential" conflict due to the possibility of an entrenchment motive. During the same period, the Chancery Court relied on a traditional business judgment rule analysis to resolve "*Revlon*" claims attacking the conduct of directors in a corporate auction or other change-of-control setting.

As discussed in Part III, *Macmillan* soon announced that some form of enhanced scrutiny would govern claims even in the sale-of-control context—at least in takeover cases involving disparate treatment of competing bidders—not just when directors use defensive measures to avoid a takeover. In either setting, enhanced scrutiny continued to rest on the proposition that directors face a potential conflict of interest regardless of whether they are facilitating or resisting a change-of-control transaction.

III. *Macmillan* and Its Progeny—Enhanced Scrutiny and the "Omnipresent Specter" Rationale in Corporate Auctions

The Delaware Supreme Court announced in *Mills Acquisition Co. v. Macmillan, Inc.*[182] that enhanced scrutiny also would be applied to the conduct of directors in the sale of a corporation. The courts thereafter applied such scrutiny to change-of-control transactions, citing the *Macmillan* court's importation of the "omnipresent specter" rationale from *Unocal* into the *Revlon* setting.[183]

A. *Macmillan*

In *Macmillan*, the Delaware Supreme Court reversed the Chancery Court's refusal to enjoin an asset lock-up agreement and other measures that improperly ended an auction for control of Macmillan.[184] Although the Chancery Court found that KKR, the winning bidder, received preferential treatment throughout the auction, it con-

182. 559 A.2d 1261 (Del. 1989).

183. *Id.* at 1287; *see also infra* notes 207-224 and accompanying text.

184. *Id.* at 1264-65, 1288. The written opinion in *Macmillan* was issued in May 1989, some six months after the Delaware Supreme Court announced its decision in open court following oral argument. *Id.* at 1265 n.2.

cluded that such favoritism was not "material" because rival suitor Robert Maxwell was neither misled nor deterred from submitting a prevailing bid.[185] Consequently, it declined to enjoin the asset lock-up option granted to KKR.[186]

The Delaware Supreme Court reversed, concluding that the appropriate standard of review was one of entire fairness.[187] The court reasoned that the protection of the business judgment rule was unavailable because (i) Macmillan's management directors breached their duty of loyalty (by according special treatment to KKR as management's favored bidder) and (ii) the company's outside directors breached their duty of care (by failing to exercise appropriate supervision over the auction).[188] The Supreme Court also had little difficulty concluding that the board's conduct in the auction "fail[ed] all basic standards of fairness."[189] Among other things, KKR repeatedly received tactical advantages denied Maxwell, including clandestine "tips" about Maxwell's bids and access to the company's confidential

185. *Id.* at 1264, 1278-79.

186. *Id.* at 1278-79. The Chancery Court enjoined the operation of the company's poison pill, however, because it concluded that the company's shareholders should have the opportunity to consider Maxwell's alternative bid. *Id.* at 1278.

187. *Id.* at 1265, 1279-81.

188. *Id. See also id.* at 1265 ("With the divided loyalties that existed on the part of certain directors, and the absence of any serious oversight by the allegedly independent directors, the governing standard was one of intrinsic fairness."). The inability of the Macmillan board to obtain the protection of the business rule thus resulted from evidence showing a dysfunctional board process—*i.e.*, a process tainted by director disloyalty and lack of care. *See, e.g., id.* at 1264 ("[T]he record reflects breaches of the duties of loyalty and care by various corporate fiduciaries which tainted the evaluative and deliberative processes of the Macmillan board . . . ."); *id.* at 1272 (management directors' search for a potential acquiror who would enhance management group's equity position "undoubtedly led to the tainted process which we now confront"); *id.* at 1280-81 ("While any one of the identifiable breaches of fiduciary duty, standing alone, should easily foretell the outcome, what occurred here, including the lack of oversight by the directors, irremediably taints the design and execution of the transaction."); *id.* at 1283 (management directors' failure to disclose "tip" and other favoritism to KKR constituted a "fraud upon the board"). *See generally supra* Part II.B.

189. *Id.* at 1280. Notably, the court condemned the management directors for their acts of disloyalty with as much force as it chastised the outside directors for their failure to exercise appropriate oversight. *Compare id.* at 1279 (referring to the "illicit manipulation of a board's deliberative processes by self-interested corporate fiduciaries") *and id.* at 1282 (management directors' "knowing concealment of the tip at the critical board meeting of September 27th utterly destroys their credibility") *with id.* at 1280 ("The board was torpid, if not supine, in its efforts to establish a truly independent auction. . . . [T]he board materially contributed to the unprincipled conduct of those upon whom it looked with a blind eye.") *and id.* at 1281 ("[A] board of directors . . . may not avoid its active and direct duty of oversight in a matter as significant as the sale of corporate control.").

financial information.[190] The Supreme Court also concluded that senior management and the company's financial advisor committed a "fraud upon the board" by failing to disclose the tips that KKR had received in the final round of bidding.[191]

(1) Enhanced Scrutiny for Auctions

The Delaware Supreme Court's entire fairness analysis was sufficient to resolve the appeal in *Macmillan.* Nevertheless, the court added a discussion at the end of its opinion expounding on the nature of directors' duties, and on the role of the reviewing court, in the context of an auction.[192] Significantly, *Macmillan* announced that the "enhanced duty" *Unocal* imposes on directors who seek to thwart a takeover also arises when directors oversee an auction for corporate control.[193] Thus, by broadening *Unocal*'s "omnipresent specter" rationale for antitakeover cases to encompass any case "where issues of corporate control are at stake,"[194] the Delaware Supreme Court imported the concept of enhanced scrutiny from *Unocal* into the *Revlon* context.[195]

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190. *Id.* at 1281, 1283. The court also determined that Macmillan's financial advisors deliberately misled Maxwell at the end of the auction by purposefully failing to disabuse Maxwell of his mistaken belief that he had submitted the highest bid. *Id.* at 1281.

191. *Id.* at 1283. The court also analyzed the asset lock-up option within the *Revlon* framework. *Id.* at 1286. The court determined that the lock-up was invalid because it was not necessary to draw any of the bidders into the contest, and it effectively ended the auction in exchange for an increase in KKR's bid that was "nominal at best." *Id.*

192. *Id.* at 1286-88.

193. The court thus observed:

> [L]ike any other business decision, the board has a duty in the design and conduct of an auction to act in "the best interests of the corporation and its shareholders." *Unocal*, 493 A.2d at 954-56; *Ivanhoe*, 535 A.2d at 1341-42.
>
> However, as we recognized in *Unocal*, where issues of corporate control are at stake, there exists "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders." *Unocal*, 493 A.2d at 954. For that reason, an "enhanced duty" must be met at the threshold before the board receives the normal protections of the business judgment rule.

Id. at 1287. The *Macmillan* court also observed that there is no legally-mandated formula for directors to follow in conducting an auction, "only that they observe the significant requirement of fairness for the purpose of enhancing general shareholder interests." *Id.* at 1286; *see also* Barkan v. Amsted Indus., 567 A.2d 1279, 1286 (Del. 1989).

194. *Macmillan*, 559 A.2d at 1287.

195. *Id.* The Delaware Supreme Court also noted disapprovingly that the Chancery Court had not explicitly applied *Unocal*'s enhanced scrutiny in earlier cases involving "*Revlon*" claims. *Id.* at 1287-88; *In re* RJR Nabisco, Inc. Shareholders Litig., C.A. No. 10389, 1989 Del. Ch. LEXIS 9 (Del. Ch. Jan. 31, amended Feb. 14, 1989); *In re* Holly Farms Corp. Shareholders Litig., C.A. No. 10350, 1989 Del. Ch. LEXIS 71 (Del. Ch. Dec. 30, 1988); *In re* Fort Howard Corp. Shareholders Litig., C.A. No. 9991, 1988 Del. Ch. LEXIS

(2) *Enhanced Scrutiny for Every Auction?*

The scope of *Macmillan*'s enhanced scrutiny pronouncement was unclear, however. Certain language in the opinion construing *Revlon* suggested that enhanced scrutiny would apply in every corporate auction.[196] On the other hand, *Macmillan*, like *Revlon*, involved a sale of control in which the auctioneers improperly "play[ed] favorites with the contending factions."[197] Moreover, *Macmillan* strongly suggested that enhanced scrutiny "only" is applied in an auction setting when competing bidders receive "unequal" treatment:

> At the outset, the plaintiff must show, and the trial court must find, that the directors of the target company treated one or more of the respective bidders on unequal terms. *It is only then* that the two-part threshold requirement of *Unocal* is truly invoked, for in *Revlon* we held that . . . "directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions."[198]

Thus, although *Macmillan* could be read broadly as requiring enhanced scrutiny in every auction, the court suggested a narrower interpretation.[199]

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110 (Del. Ch. Aug. 8, 1988); *In re* J.P. Stevens & Co. Shareholders Litig., 542 A.2d 770 (Del. Ch. 1988). Nevertheless, while noting that the Chancery Court appeared to have applied an "ordinary business judgment rule analysis," the *Macmillan* court determined that the it had been applying a de facto enhanced business judgment rule analysis. *Id.* at 1288 & n.40 (citing *Fort Howard*, 1988 Del. Ch. LEXIS 110, at *35). *See generally supra* Part II.C(2).

196. The *Macmillan* court stated as follows:

> Although the board's *responsibilities* under *Unocal* are far different, the enhanced *duties* of the directors in responding to a potential shift in control, recognized in *Unocal*, remain unchanged. This principle pervades *Revlon*, and when directors conclude that an auction is appropriate, the standard by which their ensuing actions will be judged continues to be the enhanced duty imposed by this Court in *Unocal*.

Id. at 1287 & n.39 (footnote omitted). *Cf. id.* at 1285 ("*At a minimum, Revlon* requires that there be the most scrupulous adherence to *ordinary principles of fairness* . . . .") (emphasis added).

197. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986); *see also Macmillan*, 559 A.2d at 1277-78.

198. *Macmillan*, 559 A.2d at 1288 (emphasis added) (quoting *Revlon*, 506 A.2d at 184).

199. *See also* Prentice & Langmore, *supra* note 85, at 467 (*Macmillan* "extended *Revlon*'s enhanced standard of review to the auction context, requiring whenever a board running an auction extends concessions or benefits to one of the bidders, that the action be reasonable in relation to the threat to be avoided or to the benefit to be gained") (footnote omitted); Comment, Yanow v. Scientific Leasing, Inc.*: "Enhanced Scrutiny"—Delaware's Judicial Standard of Review for a Single Bid Corporate Acquisition?*, 18 DEL. J. CORP. L. 139, 151 (1993) (observing that the *Macmillan* court "refined the application of the *Unocal* test to *Revlon* situations, by stating that when *Revlon* duties attach, directors' actions would be reviewed under the *Unocal* enhanced scrutiny standard *only if* there was disparate treatment of one or more bidders") (footnotes omitted) (emphasis added); Note, *When Delaware Corporate Managers Turn Auctioneers: Triggering The* Revlon *Duty After*

This narrower reading of *Macmillan* was also logically sound. In borrowing *Unocal*'s "omnipresent specter" rationale for use in the *Revlon* context, the *Macmillan* court did not explain why the motives of a predominantly disinterested board should automatically be regarded with suspicion. Certainly questions of improper motive do not arise simply because directors have decided to sell the company (and thus have acted against the potential self-interest in maintaining control addressed in *Unocal*).[200] Something more—like the "disparate treatment" of competing bidders—would appear to be required before enhanced scrutiny would be triggered in an auction.[201] Only at that point have the directors arguably engaged in conduct (comparable to the adoption of defensive measures in the *Unocal* context) that gives one grounds to question their motives.[202] Thus, "only then"[203] should the directors be required to demonstrate at the threshold that

the Paramount *Decision*, 16 DEL. J. CORP. L. 187, 195 (1991) ("Board decisions made while under the *Revlon* duty are afforded the protection of the business judgment rule, unless a showing has been made that bidders in the corporate auction were treated on unequal terms."). Interestingly, the *Paramount* court quoted extensively from this portion of the *Macmillan* opinion but omitted any reference to the "only then" analysis. Paramount Communications v. QVC Network, 637 A.2d 34, 45 & n.16 (Del. 1994).

The Delaware Supreme Court also has alluded to *Revlon*'s uncertain boundaries and requirements. *See, e.g., Macmillan*, 559 A.2d at 1285 ("*At a minimum*, *Revlon* requires that there be the most scrupulous adherence to *ordinary principles of fairness* . . . .") (emphasis added); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 68 (Del. 1989) ("To the extent that *Revlon* instructs a board to obtain the best available transaction for its shareholders, the Fairchild directors complied with *Revlon*."); *id.* (third party's "failure to submit a firm and unconditional offer *precluded a bidding contest foreclosing plaintiffs' reliance on* Revlon.") (emphasis added).

200. Note, Mills Acquisition Co. v. Macmillan, Inc.*: Corporate Auctions Now Require Sharper Supervision By Directors*, 39 AM. U.L. REV. 721, 759 (1990) [hereinafter Macmillan Note] (analyzing *Macmillan* court's reliance on *Unocal*'s "omnipresent specter" rationale for review of conduct of board in auction context); Note, *Review of Board Actions: Greater Scrutiny for Greater Conflicts of Interest*, 103 HARV. L. REV. 1697 (1990) [hereinafter Conflicts Note] (*Macmillan*'s "joint application" of *Revlon* and *Unocal* "seems logically inconsistent"); *but see* Theodore N. Mirvis, **Paramount** *I and II: The Bookends of Delaware Law*, 12 BANK & CORP. GOVERNANCE L. REP. 63 (1994) (arguing that *Paramount*'s enhanced scrutiny test for all change-of-control transactions is warranted because of the potential for improperly motivated board action in every auction).

201. *Macmillan*, 559 A.2d at 1288.

202. Disparate treatment arouses the suspicion that a board may be improperly motivated (and/or unduly influenced by senior management) to steer a transaction to a bidder who appears friendly to incumbent executives. *See infra* notes 348-350 and accompanying text; *see also infra* note 223.

203. *Macmillan*, 559 A.2d at 1288.

there is "a rational basis for the action such that the interests of the stockholders are manifestly the board's paramount objective."[204]

B. *Macmillan*'s Progeny

After *Macmillan*, the Delaware courts continued to invoke *Unocal*'s "omnipresent specter" as the rationale for applying enhanced scrutiny in change-of-control transactions.

(1) Delaware Supreme Court Decisions

In *Barkan v. Amsted Industries*,[205] the Delaware Supreme Court applied enhanced scrutiny in affirming the Chancery Court's approval of a class action settlement involving a management-sponsored leveraged buy out of Amsted Industries, Inc.[206] One of the various shareholder plaintiffs opposed the settlement, asserting that the directors of Amsted had breached their *Revlon* duties by selling the company in a manner not designed to maximize the price paid to shareholders.[207] Noting that the principles of *Unocal* applied to a change-of-control transaction, the Delaware Supreme Court emphasized what it regarded as the potential for self-interested decisions by directors in this context:

> We believe that the general principles announced in *Revlon*, in *Unocal* . . . and in *Moran* . . . govern this case and every case in which a fundamental change of corporate control occurs or is contemplated . . . . [A] court evaluating the propriety of a change of control or a takeover defense must be mindful of "the omnipresent specter that

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204. *Id.* at 1287. The *Macmillan* court articulated the following test of enhanced scrutiny for addressing instances of disparate treatment of competing bidders in an auction for corporate control:

> In the face of disparate treatment, the trial court must first examine whether the directors properly perceived that shareholder interests were enhanced. In any event the board's action must be reasonable in relation to the advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests.

Id. at 1288 (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)).

205. 567 A.2d 1279 (Del. 1989).

206. *Id.* at 1286.

207. *Id.* at 1285. Among other things, the shareholder plaintiff opposing the settlement took issue with the board's "passive" approach to the sale of the company (which was limited to negotiations between a special committee of independent directors and the management buy-out group). *Id.* at 1283, 1286-88. The Amsted board did not conduct an auction for the company or canvass the market to determine whether higher bids could be elicited. *Id.* at 1287. *See, e.g.,* Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 731 (1985) (arguing that the law should require open bidding when management proposes a buy out and that "other potential buyers should be given the time and the information necessary to bid").

> a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[208]

The Supreme Court affirmed the Chancery Court's approval of the settlement, noting that the Amsted directors "could conclude in good faith that they had approved the best possible deal for shareholders."[209]

Later decisions of the Delaware Supreme Court provided further (albeit limited) insight into the nature of a board's "enhanced duty" in the context of a sale of control. *Citron v. Fairchild Camera & Instrument Corporation*,[210] a decision announced only four days after *Barkan*, proceeded for the most part on a traditional business judgment rule analysis in assessing the conduct of the directors of Fairchild Camera & Instrument Corporation in auctioning the company.[211] Briefly addressing the "subordinate" issue of the plaintiffs' *Revlon* claim,[212] the *Citron* court affirmed the Chancellor's findings that the Fairchild board had not "'play[ed] favorites,' consistent not only with *Revlon* but with any 'enhanced' duty which . . . was enunciated under *Unocal* . . . ."[213]

In *Time-Warner*,[214] the Delaware Supreme Court applied a *Unocal* analysis to uphold a decision by the Time directors to "recast" Time's merger agreement with Warner Communications, Inc. in response to an unsolicited tender offer by Paramount Communications, Inc. for any and all shares of Time.[215] *Time-Warner* actually was not a

208. *Barkan*, 567 A.2d at 1286 (citations and footnote omitted) (quoting *Unocal*, 493 A.2d at 954). The court in *Barkan* similarly observed that *Revlon* sought to prevent the "conflicts of interest that arise" in the takeover context "by demanding that directors act with scrupulous concern for fairness to shareholders." *Id.* at 1286.

209. *Id.* at 1288.

210. 569 A.2d 53 (Del. 1989).

211. *See, e.g., id.* at 64. Although the change-of-control transaction in *Citron* occurred in 1979, the court, citing *Barkan*, assumed that "*Revlon* strictures apply retroactively." *Id.* at 68.

212. *Id.* at 67.

213. *Id.* at 68. *See also* Gilbert v. El Paso Co., 575 A.2d 1131, 1146 (Del. 1990) (suggesting continued application of enhanced scrutiny when board moved from antitakeover strategy to rapprochement with unwelcome suitor) (citing Mills Acquisition Co. v. Macmillan, 559 A.2d 1261, 1287 (Del. 1989)); *id.* at 1148 ("When the sale of El Paso became inevitable, the El Paso board properly attempted to obtain the highest price and best transaction for the company and all its shareholders. Their actions survive the enhanced *Unocal* scrutiny.").

214. Paramount Communications v. Time, Inc., 571 A.2d 1140 (Del. 1990).

215. *Id.* at 1152-55. The original merger agreement between Time and Warner contemplated a combination of the two companies through a stock-for-stock merger transaction. *Id.* at 1146. The rules of the New York Stock Exchange (but not Delaware law) required that Time shareholders vote to approve the issuance of Time shares required by the proposed merger. *Id.* After Time mailed out proxy statements soliciting the shareholders'

Revlon case, the court reasoned, because the evidence did not show that Time's board, in negotiating an agreement with Warner, made the dissolution or break-up of the company inevitable.[216] Although for this reason the *Time-Warner* court ruled *Revlon* inapplicable, it nevertheless suggested that enhanced scrutiny must be applied whenever *Revlon* duties are in fact triggered. The court thus observed that "[w]ithin the auction process, any action taken by the board must be reasonably related to the threat posed or reasonable in relation to the advantage sought . . . ."[217]

(2) Chancery Court Decisions

In *Roberts v. General Instrument Corp.*,[218] the Chancery Court applied enhanced scrutiny in refusing to enjoin a tender offer by Forstmann Little for all shares of General Instrument pursuant to a negotiated acquisition agreement. Citing *Macmillan*'s criticism of the Chancery Court's use of an "ordinary" business judgment analysis for resolving *Revlon* claims in earlier cases,[219] the Chancellor paused to observe that "[t]his court has been pointedly instructed" to apply "an enhanced test" in such circumstances.[220]

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vote on the merger, Paramount announced a tender offer to purchase all shares of Time for $175 in cash per share (later increased to $200). *Id.* at 1147. Fearing a disapproving shareholder vote on the merger, Time's directors decided to "recast" the combination whereby Time would (i) launch a cash tender offer for 51% of Warner's stock in cash and (ii) subsequently acquire the remaining Warner shares in exchange for a combination of cash and securities. *Id.* at 1148-49.

216. *Id.* at 1150. The *Time-Warner* court's emphasis on the dissolution or breakup of the company as the trigger for *Revlon* duties—contrasted with the Chancellor's reliance on a change-of-control test—engendered some speculation that a change-of-control transaction that left the acquired company intact might not trigger *Revlon*. *See infra* notes 282-285 and accompanying text.

217. *Id.* at 1151 n.14 (citations omitted); *see also* Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1941 (1991) (characterizing the decision in *Time-Warner* as a "Doctrinal Retreat": "The Supreme Court seems to reject the Chancery's enhanced review of board decisions in favor of a simple business judgment test that unwinds *Unocal*.").

218. C.A. No. 11639, 1990 Del. Ch. LEXIS 138 (Del. Ch. Aug. 13, 1990), *reprinted in* 16 DEL. J. CORP. L. 1540 (1991).

219. *See supra* notes 165-182 and accompanying text.

220. *Roberts*, 1990 Del. Ch. LEXIS 138, at *23. The Chancellor thus explained:

> In each instance where the board is not predominantly self-interested or under the control or dominating influence of a person with a conflicting interest, the principal judicial inquiries relate to whether the board was adequately informed and acting in good faith. This court has been pointedly instructed, however, that "where issues of corporate control are at stake" action of even a disinterested board must meet an enhanced test before they will qualify for the deference that courts ordinarily accord to good faith business judgments.

Roberts also reflected a clear understanding that the Delaware Supreme Court's rationale for enhanced scrutiny in the takeover setting was the "omnipresent" concern for improperly motivated board action. For example, in referring to the "enhanced" level of judicial review, the court in *Roberts* quoted *Barkan*'s reference to the "omnipresent specter" in the context of a "change of control *or* a takeover defense . . . ."[221] The Chancellor also effectively distilled the principle of enhanced scrutiny in the *Revlon* setting into an inquiry that includes an assessment of the bona fides of the decisionmakers:

> In such a setting the additional level of inquiry comes to this: whether the circumstances afford a disinterested and well motivated director a basis reasonably to conclude that if the transactions contemplated by the merger agreement close, they will represent the best available alternative for the corporation and its shareholders.[222]

The court concluded that the General Instrument board acted reasonably in negotiating the acquisition, because, among other things, the directors (i) acted with adequate information and (ii) negotiated a "fiduciary out" that preserved the company's right to pursue a better transaction if one became available.[223]

Id. at *23-24 (citing Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287-88 (Del. 1989)).

The court in *Roberts* also implied that *Macmillan* was unclear as to whether enhanced scrutiny was required in all takeovers or only in auctions involving unequal treatment of competing bidders: "This enhanced test requires a judicial judgment of reasonableness in the circumstances. It is plainly required when, in the course of an auction sale, some discrimination in favor of one party is shown . . . ." *Id.* at *24. The Chancellor sidestepped this debate, however, by concluding that the mere signing of a merger agreement like the one in *Roberts*, "even an agreement with a fiduciary-out, constitutes discrimination in favor of the party acquiring rights under the merger agreement," and thus triggers the enhanced scrutiny of *Macmillan*. *Id.*

221. *Id.* at *22 (emphasis added) (quoting Barkan v. Amsted Indus., 567 A.2d 1279, 1286 (Del. 1989)).

222. *Id.* at *24-25. Elsewhere in the opinion, the Chancellor appeared to link the court's enhanced scrutiny of the directors' conduct with a concern for the motives of directors in the takeover context. *See id.* at *25-26 ("The first question . . . is whether this transaction is . . . a bargain reached at arm's length . . . or whether it is a transaction in which a senior management, hopeful of participating with the buyer in the future ownership of the enterprise, affected negotiations by assisting the buyer to the shareholders detriment."); *id.* at *28 ("I cannot provisionally conclude that the special committee was not appropriately informed, was inappropriately manipulated to the shareholders detriment or behaved unreasonably in relation to the goal they sought to obtain.").

223. *Id.* at *27-28. *See also In re* Vitalink Communications Corp. Shareholders Litig., C.A. No. 12085, 1991 Del. Ch. LEXIS 195, at *14 (Del. Ch. Nov. 8, 1991) (adopting the *Roberts* analysis and applying enhanced scrutiny to assess the strength of claims to be released in a settlement arising out of a negotiated acquisition transaction); *id.* at *35-36 (concluding that the board satisfied its duty of care by having a "body of reliable evidence

(3) Summary

Macmillan announced that the decisions of an informed and disinterested board in the context of a change-of-control transaction may be subjected to enhanced scrutiny. For example, *Macmillan* plainly requires such scrutiny of a board's decision to treat competing bidders unequally. The court was less clear, however, on whether enhanced scrutiny applies in *every* change-of-control transaction—as now required by *Paramount*.[224] In all events, the development of enhanced scrutiny through *Macmillan* and its immediate progeny reveals a continuing concern for the "omnipresent specter" that even a disinterested board may be improperly motivated when overseeing the sale of a company.

IV. *Paramount*—From "Omnipresent Specter" to Transaction Significance—the New Justification for Enhanced Judicial Scrutiny

In *Paramount Communications v. QVC Network*,[225] the Delaware Supreme Court affirmed the Chancery Court's decision to enjoin a stock option agreement and other defensive measures (including Paramount's poison pill Rights Agreement) that were designed to facilitate Viacom's proposed acquisition of Paramount Communications. The court ruled that the Paramount directors acted unreasonably by holding steadfast in their commitment to merge with Viacom and resisting QVC Network's more valuable acquisition proposals.[226]

Both the Paramount board's use of defensive measures and its discriminatory treatment of QVC as a competing bidder offered the court an opportunity to apply enhanced scrutiny based on the "omnipresent specter" rationale of earlier precedent. Instead, the Delaware Supreme Court announced a more sweeping formulation of the enhanced scrutiny test. The court's latest pronouncement on enhanced scrutiny requires a judicial assessment of the "reasonableness" of directors' conduct, including the substance of the decisions they make, in every change-of-control transaction.[227] Gone, apparently, is the court's earlier concern for the elusive "specter" of potential conflicts that even outside directors are thought to face "where issues of corpo-

[upon which it] could reasonably conclude that it was getting the best deal possible for Vitalink's shareholders") *aff'd mem.*, 610 A.2d 725 (Del. 1992).

224. *See infra* Part IV.

225. 637 A.2d 34 (Del. 1994).

226. *Id.* at 48-50.

227. *Id.* at 45.

rate control are at stake."[228] Instead, *Paramount* emphasizes the "considerable significance"[229] of a change-of-control transaction as the justification for requiring heightened judicial scrutiny in such cases. According to the court, such scrutiny is necessary in transactions as significant as a sale of control "to ensure" that "the directors' conduct . . . is reasonable."[230]

As discussed below, the court's newly adopted role as insurer of the reasonableness of all "significant" board decisions has disturbing implications for the business judgment rule. *Paramount* essentially reflects a policy judgment that takeovers are simply too important to shareholders to accord deference to directors' decisions, even when the board is informed, disinterested, and acting in good faith. The court, in effect, has identified takeovers as a special category of transactions ineligible for traditional business judgment rule protection. In furtherance of this new policy, the *Paramount* court has instituted judicial review of the reasonableness, or fairness, of every change-of-control transaction. The decision thus suggests an unwelcome shift in Delaware's model of corporate governance to a scheme that unnecessarily elevates the value of accountability to shareholders at the expense of managerial authority and discretion.

A. Factual Background of the *Paramount* Decision

Paramount and Viacom explored the possibility of a combination as early as 1990, but meaningful efforts to pursue a transaction did not occur until 1993.[231] In early July of 1993, serious negotiations occurred between Sumner Redstone—the chairman, chief executive officer, and controlling stockholder of Viacom—and Martin Davis—the chairman and chief executive officer of Paramount.[232] They tentatively agreed that Davis would become chief executive and Redstone would be the controlling stockholder of the combined company.[233] The Paramount board was informed of the status of the negotiations

228. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287 (Del. 1989).

229. *Paramount*, 637 A.2d at 43.

230. *Id.* at 42. *See also id.* at 43 ("[t]he courts will apply enhanced scrutiny to ensure that the directors have acted reasonably").

231. *Id.* at 38. In the late 1980s, Paramount investigated the possibility of acquiring or combining with other companies in the entertainment, media, or communications industry. *Id.* at 38. In furtherance of this strategy, Paramount made an unsuccessful tender offer for Time in 1989. *Id. See* Paramount Communications v. Time, Inc., 571 A.2d 1140, 1142 (Del. 1990).

232. *Paramount*, 637 A.2d at 38.

233. *Id.*

and thereafter approved an Original Merger Agreement between Paramount and Viacom.[234]

In the merger as originally conceived, Paramount shareholders would exchange their shares for a combination of Viacom stock and cash valued at $69.14 per share.[235] Redstone, because of his substantial ownership of Viacom, would emerge as controlling stockholder of the combined Viacom-Paramount entity.[236] The Paramount directors also agreed to three defensive provisions: a No-Shop provision, a Termination Fee, and a Stock Option Agreement.[237] The Stock Option Agreement—regarded by the Delaware Supreme Court as the "most significant deterrent device"[238]—granted Viacom an option to purchase 19.9% (approximately 23.7 million shares) of Paramount's outstanding common stock at the "deal price" of $69.14 per share.[239] Viacom's right to exercise this option would arise if any of the triggering events for the Termination Fee occurred.[240]

One week after Paramount's agreement to merge with Viacom was announced,[241] QVC proposed a transaction in which QVC would

234. *Id.* at 39.

235. QVC Network v. Paramount Communications, 635 A.2d 1245, 1250 (Del. Ch. 1993), *aff'd*, 637 A.2d 34 (Del. 1994). Under the terms of the Original Merger Agreement, Paramount would merge into Viacom, and each share of Paramount common stock would be converted into: (i) one-tenth of a share of Viacom Class A Voting Stock; (ii) nine-tenths of a share of Viacom Class B Non-Voting Stock; and (iii) $9.10 in cash. *Paramount*, 637 A.2d at 39.

236. *Paramount*, 637 A.2d at 38; *QVC*, 635 A.2d at 1265.

237. *Paramount*, 637 A.2d at 39. Under the No-Shop provision, the Paramount directors committed not to solicit any other acquisition proposal and not to pursue a competing transaction unless a third party made an unsolicited written proposal that was not subject to any financing contingencies. *Id.* Essentially, the Termination Fee obligated Paramount to pay Viacom a fee of $100 million if the Viacom-Paramount merger was not consummated. *Id.*

238. *Id.*

239. *QVC*, 635 A.2d at 1271; *Paramount*, 637 A.2d at 39. The Stock Option Agreement also contained two provisions that the court regarded as "unusual and highly beneficial to Viacom." *Id.* The first of these, a "Note Feature," enabled Viacom to pay for the option shares with a "senior subordinated note of questionable marketability" instead of the $1.6 billion in cash that otherwise would be necessary. *Id.* The second was a "Put Feature," under which Viacom could simply elect to require Paramount to pay it the value of the option in cash. *Id.* This "value" would be the difference between the exercise price of $69.14 and the market price of Paramount's stock when the put was exercised. *Id.*

240. *Id.* The Termination Fee (and Viacom's rights under the Stock Option Agreement) would be triggered if (a) Paramount terminated the Original Merger Agreement because of a competing transaction; (b) the shareholders of Paramount did not approve the merger; or (c) the Paramount directors recommended a competing transaction. *Id.*

241. When Paramount and Viacom announced the proposed merger, Redstone described the transaction as a "'marriage'" that would "'never be torn asunder'" and stated that "only a 'nuclear attack' could break the deal." *Id.*

acquire Paramount in exchange for a package of securities and cash worth approximately $80 per share, over $10 more per share than the consideration offered to Paramount shareholders by Viacom.[242] Although the Paramount board eventually authorized management to meet with QVC, discussions proceeded slowly.[243] QVC, therefore, announced its intention to launch a tender offer for 51% of Paramount's outstanding shares at $80 in cash per share.[244] The QVC tender offer was conditioned on the invalidation of the Stock Option Agreement, which at that point was worth more than $200 million to Viacom.[245]

Within hours after QVC announced its tender offer, Viacom and Paramount opened discussions for a revised transaction and "serious negotiations" ensued.[246] These negotiations led to an Amended Merger Agreement in which Viacom agreed (i) to make a tender offer for 51% of Paramount's stock at $80 in cash per share and (ii) to acquire the remaining shares in exchange for Viacom securities.[247] Significantly, however, the "defensive measures" (including the Stock Option Agreement) that were "designed to make a competing bid more difficult were not removed or modified."[248] Nor did Paramount seek to exploit its new leverage with Viacom by attempting to eliminate or modify these measures.[249]

In keeping with its obligations under the Amended Merger Agreement, Viacom promptly commenced its tender offer; QVC's tender offer formally commenced two days later.[250] QVC Chairman Barry Diller then met with representatives of Paramount to propose

242. *Id.* at 39-40.

243. *Id.* at 40.

244. *Id.* Under the terms of QVC's proposal, the shares of Paramount stock not acquired in the tender offer would be converted into shares of QVC common stock in a second-step merger. *Id.*

245. *Id.* With the market price of Paramount's stock rising in response to increasing bids by Viacom and QVC, the value of the Stock Option Agreement to Viacom soon increased to nearly $500 million. *Id.* at 40 n.5.

246. *Id.* at 40. The Supreme Court emphasized that QVC's emergence as a rival bidder gave the Paramount board "considerable leverage" and "the opportunity for a 'new deal' with Viacom . . . ." *Id.*

247. *Id.* The Amended Merger Agreement also gave Paramount some added flexibility. Paramount reserved the right to use its poison pill to block the Viacom transaction if Paramount's directors determined that their fiduciary duties required them to pursue a better alternative. *Id.*

248. *Id.*

249. *Id.* at 41.

250. *Id.*

"'auction procedures'" for a "'fair bidding process.'"[251] Diller was rebuffed, however. Paramount asserted that auction procedures were inappropriate and not in keeping with Paramount's contractual obligations to Viacom.[252]

Thereafter, Viacom unilaterally increased its tender offer price to $85 per share and offered a comparable increase in the value of securities to be exchanged in the second-step merger transaction.[253] QVC promptly increased its tender offer from $80 to $90 per share and increased the value of the securities in its second-step merger proposal by a comparable amount.[254] At this point, QVC's $90 bid exceeded Viacom's $85 offer by more than $1 billion in overall transaction value.[255] The Paramount directors nevertheless determined that QVC's latest offer was not in the shareholders' best interests, purportedly because (i) the QVC bid was "excessively conditional" and (ii) the Viacom transaction offered more promising future business prospects than the QVC proposal.[256]

The Chancery Court determined that the Paramount directors came under, but failed to satisfy, *Revlon*'s mandate to seek the best available transaction when they committed Paramount to a merger that would shift majority voting control from the company's public

251. *Id.*

252. *Id.* Paramount's response in this regard reveals the larger legal dispute that caused Paramount to lose the case. Relying on *Time-Warner—see supra* notes 215-218 and accompanying text—Paramount essentially asserted that it was free to rebuff QVC's higher bids because its proposed merger with Viacom did not contemplate a "break-up" of Paramount and thus did not trigger *Revlon* duties. *Id.* at 46; *see also* QVC Network v. Paramount Communications, 635 A.2d 1245, 1263-64 (Del. Ch. 1993), *aff'd*, 637 A.2d 34 (Del. 1994). Given their perception that *Revlon* was inapplicable, Paramount's directors apparently concluded that they were free to hold fast to a strategic combination with Viacom that they believed offered brighter future economic prospects than a takeover by QVC. *Paramount*, 637 A.2d at 46. Both the Chancery Court and Supreme Court rejected this argument because (i) Redstone would emerge as controlling stockholder of the combined Viacom-Paramount enterprise (whereas, in *Time-Warner*, control would remain among the disaggregated public stockholders) and (ii) such a change of control, whether or not accompanied by a breakup of the company, was ruled sufficient to trigger the *Revlon* duty to seek the highest possible price for shareholders. *Id.* at 38, 46-48; *QVC*, 635 A.2d at 1264-67.

253. *Paramount*, 637 A.2d at 41.

254. *Id.*

255. *Id.* at 50; *QVC*, 635 A.2d at 1256, 1269-70.

256. *Paramount*, 637 A.2d at 41. Prior to the Paramount directors' meeting to consider QVC's $90 bid, Paramount Executive Vice President Donald Oresman circulated a memorandum to the directors summarizing what Oresman listed as the "'conditions and uncertainties'" of the QVC offer. This analysis left at least one board member with a "very negative impression of the QVC bid." *Id.*

stockholders to Sumner Redstone.[257] The Chancery Court therefore issued a preliminary injunction (i) restraining enforcement of the Stock Option Agreement and the No-Shop provision and (ii) preventing the Paramount board from using a poison pill to preclude shareholders from considering the QVC offer.[258]

B. The Supreme Court Decision

The Supreme Court affirmed, ruling that the Paramount directors breached their fiduciary duties by approving the Original Merger Agreement with Viacom and by subsequently resisting QVC's more valuable acquisition proposals.[259] Applying *Revlon* and a newly formulated enhanced scrutiny test, the court concluded that "the Paramount directors' *process* was not reasonable, and the *result achieved* for the stockholders was not reasonable under the circumstances."[260]

In approving the Original Merger Agreement, the Paramount directors "gave insufficient attention to the potential consequences of the defensive measures demanded by Viacom."[261] These defensive provisions, including the Stock Option Agreement, were problematic because they made Paramount less attractive to other bidders.[262] The Paramount directors also breached their fiduciary duties by failing to exploit the negotiating leverage they acquired with Viacom after QVC emerged as a competing bidder that "persistently demonstrated its intention to meet and exceed the Viacom offers . . . ."[263]

257. *QVC*, 635 A.2d at 1265-70.

258. *Paramount*, 637 A.2d at 36, 41; *see QVC*, 635 A.2d at 1270.

259. *Paramount*, 637 A.2d at 51.

260. *Id.* at 49 (emphasis added).

261. *Id.*

262. *Id. See also id.* at 39 ("Because the Stock Option Agreement was not 'capped' to limit its maximum dollar value, it had the potential to reach (and in this case did reach) unreasonable levels."). As Vice Chancellor Jacobs astutely observed in granting QVC's motion for a preliminary injunction, the uncapped Stock Option Agreement had the potential to reward Viacom for making a low initial bid and to unfairly penalize any competing bidder that might later emerge:

> With no upper dollar limit on the value of the stock option, that option would foreseeably operate to reward Viacom for making a low initial bid, because its value was tied to the original September 12 Viacom deal price of $69.14. If a bidding contest developed, the costs to a competing bidder foreseeably could (and did) rise to stratospheric heights.

QVC, 635 A.2d at 1271.

263. *Paramount*, 637 A.2d at 49. Moreover, the directors apparently failed to appreciate that the Stock Option Agreement, Termination Fee, and No-Shop provision "were impeding the realization of the best value reasonably available to the Paramount stockholders." *Id.* at 50.

The *Paramount* court also chastised Paramount's directors for "squander[ing]" a final opportunity "to eliminate the restrictions they had imposed on themselves."[264] QVC's eventual bid of $90 per share exceeded Viacom's $85 offer by more than $1 billion in overall transaction value.[265] As the court remarked, this "significant disparity" could not be "justified on the basis of the directors' vision of future strategy, primarily because the change of control would supplant the authority of the current Paramount Board" to implement that vision "in any meaningful way."[266]

What is noteworthy about *Paramount*, however, is not the outcome of the litigation. QVC could have won under a straightforward application of *Macmillan* or *Unocal*.[267] *Paramount* is significant because the court's rationale for applying enhanced scrutiny in a corporate takeover breaks new doctrinal ground. As Chancellor Allen astutely observed in *RJR Nabisco*, "in the law, to an extent present in few other human institutions, there may be in the long run as much importance ascribed to the reasoning said to justify action, as there is in the actions themselves."[268] Thus, it is to the *Paramount* court's rationale that this Article now turns.

264. *Id.* The court also suggested that the Paramount directors improperly allowed themselves to be misled by management's self-serving criticism of the QVC offer as "conditional." *Id.*

265. *Id.*; *QVC*, 635 A.2d at 1256, 1269-70.

266. *Paramount*, 637 A.2d at 50. In the view of the *Paramount* court, the directors' "uninformed process" also deprived their "strategic vision" of much of its credibility. *Id.* This characterization of the board's process appears to be based, in part, on the fact that the directors were not provided with a "quantitative analysis of the consideration to be received by the stockholders" under the competing proposals. *Id.* at 41. The only comparison the directors received was based on then current market prices of the bidders' stock, both of which had been fluctuating constantly during the bidding process and thus were "poor measures" of the actual stock values. *Id.* at 41 & n.8. *See also id.* at 44 n.14 ("When assessing the value of non-cash consideration, a board should focus on its value as of the date it will be received by the stockholders. Normally, such value will be determined with the assistance of experts using generally accepted methods of valuation.") (citing *In re* RJR Nabisco, Inc. Shareholders Litig., C.A. No. 10389, 1989 Del. Ch. LEXIS 73 (Del. Ch. Jan. 31, amended Feb. 14, 1989)).

267. For example, the uncapped and arguably confiscatory Stock Option Agreement could have been invalidated (i) under *Macmillan* as discriminatory and unreasonable in relation to the advantage sought (a signed deal for a strategic combination with Viacom), Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1989), or (ii) under *Unocal* as an unreasonable defensive measure which, either alone or in combination with the board's selective use of the poison pill, improperly foreclosed the shareholders' opportunity to consider the far more valuable QVC offer. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985); *see also QVC*, 635 A.2d at 1270 (citing AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 116 (Del. Ch. 1986)).

268. *RJR Nabisco*, 1989 Del. Ch. LEXIS 9, at *41.

(1) Enhanced Scrutiny Reformulated

Rather than invoke the "omnipresent specter" rationale, the court in *Paramount* emphasized the "[s]ignificance" of a change-of-control transaction as the justification for heightened scrutiny.[269] First, the court emphasized that a sale of control adversely impacts the voting rights of public stockholders who are collectively relegated to a minority ownership position.[270] The majority owner of a corporation effectively controls the company's destiny.[271] Heightened scrutiny is appropriate in this context, the court reasoned, because Delaware courts traditionally have been vigilant "to protect stockholders from unwarranted interference with such [voting] rights."[272]

The court also emphasized the considerable economic significance of a takeover transaction.[273] A change-of-control transaction

269. *Paramount*, 637 A.2d at 42. The court's initial discussion of the applicable legal principles was entitled "The Significance of a Sale or Change of Control." *Id.* (footnote omitted).

270. *Id.*

271. *Id.* The *Paramount* court thus emphasized the practical reality that stockholder votes become "mere formalities" in this context because a majority stockholder can use its voting power to control the election of directors, cause a breakup of the corporation, "cash out" the public stockholders, or engage in other extraordinary transactions against the will of the minority. *Id.* at 42-43. The minority therefore "must rely for protection solely on the fiduciary duties owed to them by the directors and the majority stockholder, since the minority stockholders have lost the power to influence corporate direction through the ballot." *Id.* at 43.

272. *Id.* at 42 & n.11 (citing Schnell v. Chris-Craft Indus., 285 A.2d 437, 439 (Del. 1971); Giuricich v. Emtrol Corp., 449 A.2d 232, 239 (Del. 1982); Centaur Partners, IV v. National Intergroup, 582 A.2d 923, 927-28 (Del. 1990); Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992); Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 n.2 (Del. Ch. 1988)); *see also id.* at 45 ("[E]nhanced scrutiny . . . is mandated by . . . the threatened diminution of the current stockholders' voting power . . . and . . . the traditional concern of Delaware courts for actions which impair or impede stockholder voting rights.").

273. *Paramount*, 637 A.2d at 43. The *Paramount* court's opinion is replete with references to the significance of a change-of-control transaction as justification for enhanced scrutiny in this context. *See id.* ("The Paramount-Viacom transaction has economic consequences of considerable significance to the Paramount stockholders."); *id.* at 44 ("[T]he role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management may not necessarily be impartial."); *id.* (the board's assessment of "practical considerations relating to each alternative . . . [is] important because the selection of one alternative may permanently foreclose other opportunities"). The link between the *Paramount* court's emphasis on transaction significance and the court's perceived need for enhanced scrutiny in all takeovers is demonstrated clearly by the following discussion:

> There are few events that have a more significant impact on the stockholders than a sale of control or a corporate break-up. Each event represents a fundamental (and perhaps irrevocable) change in the nature of the corporate enterprise from a practical standpoint. It is the significance of *each* of these events that justifies: (a) focusing on the directors' obligation to seek the best value reasonably available to

presents a potentially unrecoverable opportunity for the stockholders to obtain a control premium for their shares.[274] Consequently, "[t]he courts will apply enhanced scrutiny to ensure that the directors have acted reasonably" in seeking the transaction "offering the best value reasonably available to the stockholders."[275]

Before *Paramount*, the courts had described a board's *Revlon* duties in similarly general terms.[276] *Paramount* expanded the role of the courts in this context, however, by (i) explicitly linking enhanced scrutiny to the general *Revlon* duty to seek the best deal available and (ii) announcing judicial review of the reasonableness of a board's decisions in this context.[277] The *Paramount* court explained:

> The key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decision-making process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.[278]

Paramount thus explicitly requires substantive judicial review of the merits of a board's decision in the takeover context—even decisions by a disinterested and informed board acting in good faith. To be sure, the court emphasized that judges will "not substitute their busi-

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> the stockholders; and (b) requiring a close scrutiny of board action which could be contrary to the stockholders' interests.

Id. at 47-48.

274. *Id.* at 43; *see also id.* at 45 ("[A]n asset belonging to public stockholders (a control premium) is being sold and may never be available again."); *id.* at 47-48 ("[A] sale of control . . . represents a fundamental (and perhaps irrevocable) change in the nature of the corporate enterprise from a practical standpoint."); QVC Network v. Paramount Communications, 635 A.2d 1245, 1267 (Del. Ch. 1993) ("This is the only opportunity that Paramount's shareholders will ever have to receive the highest available premium-conferring transaction."), *aff'd*, 637 A.2d 34 (Del. 1994).

275. *Paramount*, 637 A.2d at 43.

276. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1989); *see also* Barkan v. Amsted Indus., 567 A.2d 1279, 1286 (Del. 1989) ("[T]he board must act in a neutral manner to encourage the highest possible price for shareholders."); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) ("The duty of the board . . . [is] the maximization of the company's value at a sale for the stockholders' benefit."). *Macmillan* added some specific requirements of reasonableness, but this test was reserved for instances in which a plaintiff first demonstrated that a board had treated competing bidders on unequal terms. *See Macmillan*, 559 A.2d at 1288 (requiring directors, upon a plaintiff's showing of disparate treatment of competing bidders, to show that "the board's action [was] reasonable in relation to the advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests"); *see also Paramount*, 637 A.2d at 45 & n.16.

277. *Paramount*, 637 A.2d at 45.

278. *Id.*

ness judgment for that of the directors . . . ."[279] Nevertheless, reviewing courts will in fact examine the wisdom of the directors' decision in every takeover transaction to "determine if the directors' decision was, on balance, within a range of reasonableness."[280]

In sum, *Paramount* requires enhanced judicial scrutiny for "reasonableness" of *all* aspects of a change-of-control transaction—not just for suspicion-triggering board conduct such as unequal treatment of competing bidders or the adoption of defensive measures. This all-encompassing requirement is a direct result of the court's doctrinal shift from an "omnipresent specter" rationale—which arguably limited enhanced scrutiny to such suspicion-triggering conduct—to the far broader rationale of transaction "significance."

(2) Revlon *Trigger Clarified*

Paramount also removed the uncertainty left by *Time-Warner* as to whether a change-of-control transaction triggers a board's *Revlon* duty to achieve the highest value reasonably attainable for shareholders.[281] *Macmillan* and *Barkan* both stated that *Revlon* duties would arise in such circumstances.[282] *Time-Warner* introduced an element of uncertainty, however, when the Delaware Supreme Court relied on "different grounds" in affirming the lower court's ruling that *Revlon* duties did not arise.[283] Consequently, a debate ensued after *Time-Warner* as to whether the court had "narrowed the universe of *Revlon*-triggering events and eliminated 'change of control' from that universe."[284]

279. *Id.*

280. *Id.*

281. *Id.* at 48. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

282. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287 (Del. 1989) ("Although the board's responsibilities under *Unocal* are far different [when the company is for sale], the enhanced duties of the directors in responding to a potential shift in control, recognized in *Unocal*, remain unchanged.") (citation and emphasis omitted); Barkan v. Amsted Indus., 567 A.2d 1279, 1286 (Del. 1989) ("We believe that the general principles announced in *Revlon*, in *Unocal* . . . and in *Moran* . . . govern this case and every case in which a fundamental change of corporate control occurs or is contemplated.") (citations and footnote omitted).

283. *See* Paramount Communications v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1990) ("[W]e premise our rejection of plaintiffs' *Revlon* claim on different grounds, namely, the absence of any substantial evidence to conclude that Time's board, in negotiating with Warner, made the dissolution or break-up of the corporate entity inevitable, as was the case in *Revlon*.").

284. QVC Network v. Paramount Communications, 635 A.2d 1245, 1265 (Del. Ch. 1993); *see also* Black & Decker Corp. v. American Standard, Inc., 682 F. Supp. 772, 781 n.4 (D. Del. 1988) ("To require that the *Revlon* principle apply only to an offer to purchase

The *Paramount* court clarified that a transaction involving a change of control, whether or not accompanied by a break-up of the company, will trigger *Revlon* duties *and* enhanced judicial scrutiny.[285] In this regard, the *Paramount* court again emphasized the significance of, and potentially irrevocable change in a corporate enterprise that can result from, a sale of control.[286]

C. Critique of *Paramount*'s Enhanced Scrutiny Rationale

The *Paramount* court's new requirement that all corporate takeovers receive enhanced scrutiny unnecessarily expands the role of the courts. The court has shifted its threshold focus in such cases away from the integrity and effectiveness of the board's decision-making process to the significance of the transaction to be acted upon.[287] Under *Paramount*, if a sale or other change of control is proposed, the transaction is deemed significant and enhanced scrutiny is triggered even if the board (i) is informed, disinterested and independent, (ii) has acted in good faith, and (iii) has not treated competing bidders unequally or engaged in other "specter"-raising conduct.

100% of a company's stock would ignore the inevitability of a break-up which could follow a partial tender offer."); *In re* Wheelabrator Technologies, Inc. Shareholders Litig., C.A. No. 11495, Del. Ch. LEXIS 196, at *24-28 (Del. Ch. Sept. 1, 1992); Alan E. Garfield, Paramount: *The Mixed Merits of Mush*, 17 DEL. J. CORP. L. 33, 35 n.6 (1992); Note, *Defenders of the Corporate Bastion in the* Revlon *Zone:* Paramount Communications, Inc. v. Time Inc., 40 CATH. U. L. REV. 155, 181-82 (1990) (discussing Delaware Supreme Court's modification of the Chancellor's analysis in *Time-Warner* regarding the circumstances under which *Revlon* duties are triggered); Note, *Radically Altered States: Entering the* Revlon *Zone*, 90 COLUM. L. REV. 760, 766-67 (1990) (noting ambiguity in change-of-control test for triggering *Revlon* duties); Conflicts Note, *supra* note 200, at 1702 n.42 ("*Paramount*'s meaning and, hence, the definition of a transaction that 'triggers *Revlon*' remain unclear."); Note, *supra* note 199, at 240 ("Other than when a board initiates a bidding process seeking to sell itself, a board will be charged with the *Revlon* duty only if it takes action that makes the *break-up* or dissolution of the corporate entity inevitable."); *In* Paramount's *Defense*, CORP. CONTROL ALERT, Mar. 1994, at 5, 6-8 (discussing uncertainty created by *Time-Warner* decision as to whether change of control triggered *Revlon*).

285. Paramount Communications v. QVC Network, 637 A.2d 34, 47-48 (Del. 1994).

286. *Id.* The court thus observed:

> There are few events that have a more significant impact on the stockholders than a sale of control or a corporate break-up. Each event represents a fundamental (and perhaps irrevocable) change in the nature of the corporate enterprise from a practical standpoint. It is the significance of *each* of these events that justifies: (a) focusing on the directors' obligation to seek the best value reasonably available to the stockholders; and (b) requiring a close scrutiny of board action which could be contrary to the stockholders' interests.

Id.

287. *See generally supra* Parts II.A and III; Macmillan Note, *supra* note 200, at 756 ("The focus of the Macmillan holding was the conduct of the board of directors.") (footnote omitted).

The *Paramount* court's announcement that it will not defer to a board's decision in such circumstances runs counter to Delaware's long-standing model of corporate governance. First, as discussed below, the court's concern for shareholders' voting rights as a justification for enhanced scrutiny is misplaced. Second, the economic significance of a takeover, without more, does not immediately call into question the capacity of the selling corporation's board to function properly. Under Delaware's established model of governance, there must be evidence of some destabilizing influence on the board's decision-making process—*e.g.*, gross negligence, disloyalty, or that "species of director interest"[288] that arises when a board resists a takeover or otherwise acts suspiciously so that the directors' motives may legitimately be questioned—before the deference customarily accorded to facially-valid board action is displaced.[289]

288. AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 115 (Del. Ch. 1986).

289. *See generally supra* Part I.B. The *Paramount* court's holding that *Revlon* duties were triggered by the proposed change-of-control transaction with Viacom otherwise represented a sensible application of earlier precedent and a helpful clarification of *Time-Warner.* In *Time-Warner*, where *Revlon* was found inapplicable, the court gave great deference to the Time directors' vision of the long-term strategic benefits of a combination with Warner. *See* Paramount Communications v. Time, Inc., 571 A.2d 1140, 1153 (Del. 1990) (validating the directors' perception of Paramount's unsolicited offer as a threat under *Unocal* because "Time shareholders might elect to tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce"); *see also id.* ("[P]recepts underlying the business judgment rule militate against a court's engaging in the process of attempting to appraise and evaluate the relative merits of a long-term versus a short-term investment goal for shareholders."). The *Paramount* court sensibly concluded that the Paramount directors' long-term vision for the company was not dispositive of the *Revlon* issue because the contemplated change of control with Viacom "would provide the new controlling stockholder with the power to alter that vision." *Paramount*, 637 A.2d at 43; *see also* QVC Network v. Paramount Communications, 635 A.2d 1245, 1266-67 (Del. Ch. 1993) ("[O]nce the Viacom transaction is complete Mr. Redstone will have absolute control" and "shareholders can have no assurance that they will receive the long-run benefits claimed to justify the board's decision to prefer Viacom over QVC."), *aff'd*, 637 A.2d 34 (Del. 1994).

The *Paramount* court also wisely resisted making any broad doctrinal pronouncements as to the type of control that will trigger *Revlon* or, conversely, as to the types of structural protections for minority stockholders that might avoid the *Revlon* mandate in this context. A board's fiduciary duties in such circumstances necessarily will turn on the unique facts of each case. Thus, the *Paramount* court chose the better course by limiting its *Revlon*-trigger analysis to the facts before it. *Paramount*, 637 A.2d at 42 n.12, 43 n.13; *see also* Arnold v. Society For Sav. Bancorp, C.A. No. 12883, 1993 Del. Ch. LEXIS 275, at *32-34 (Del. Ch. Dec. 15, 1993) (*Revlon* not triggered in stock-for-stock merger transaction where control of merged entity remained in the public market); John L. Hardiman & James C. Morphy, Paramount v. QVC: Revlon *Withstands the Test of Time*, 12 BANK & CORP. GOVERNANCE L. REP. 57, 58 (1994); Richard D. Katcher & Steven A. Rosenblum, *Questions* Paramount *Leaves Unanswered*, 12 BANK & CORP. GOVERNANCE L. REP. 53, 55-56 (1994); Dennis J.

(1) *Takeovers and the Voting Rights Cases—A Square Peg in a Round Hole*

The *Paramount* court justified applying enhanced scrutiny in part because Paramount's proposed combination with Viacom "threatened [a] diminution of the current stockholders' voting power" and Delaware courts traditionally have demonstrated "concern . . . for actions which impair or impede stockholder voting rights . . . ."[290] To be sure, the public stockholders' collective voice would be inconsequential in a vote if Sumner Redstone acquired majority control of a combined Viacom-Paramount enterprise. It does not follow, however, that such "diminution" in voting power — incident to the disposition of one's shares for value — constitutes legally cognizable "interference" or an "impair[ment]" of the public stockholders' voting rights. Indeed, the line of authority on which *Paramount* relied for this point strongly suggests otherwise.

As the *Paramount* court recognized, the Delaware courts consistently have protected shareholders from "unwarranted interference" with voting rights.[291] Such "interference," which triggers "careful judicial scrutiny,"[292] invariably has involved inequitable conduct that is designed to thwart the existing voting rights of a company's shareholders. In *Schnell v. Chris-Craft Industries*,[293] for example, the court invalidated the decision of a company's managing directors to advance the date of an annual stockholders' meeting because the directors' action left insufficient time for an insurgent shareholder group to wage a successful proxy contest.[294] The court intervened in *Schnell* because the corporation's democratic processes had been stymied.[295] In *Gi-*

Block & Jonathan M. Hoff, *Fiduciary Duties of Directors in Negotiating Mergers*, N.Y. L.J., Apr. 14, 1994, at 7 ("[T]he [*Paramount*] court did not clarify what kinds of transactions will result in a 'sale of control' for purposes of *Revlon*.").

290. *Paramount*, 637 A.2d at 45; *see also id.* at 42-43.

291. *Id.* at 42.

292. *Id.* at 42 n.11.

293. 285 A.2d 437 (Del. 1971).

294. *Id.* at 439. The managing directors' action thus was seen as a manipulation of the "corporate machinery" for the inequitable purpose of perpetuating their control. *Id.*

295. *See also* Aprahamian v. HBO & Co., 531 A.2d 1204 (Del. Ch. 1987) (restraining attempt by incumbent board to postpone date of annual meeting when dissident stockholder group appeared to hold proxies for majority of shares); Lerman v. Diagnostic Data, Inc., 421 A.2d 906, 914 (Del. Ch. 1980) (invalidating board's reliance on bylaw to set date for annual meeting which would have precluded shareholder from conducting a proxy contest); *but see* Stahl v. Apple Bancorp, 579 A.2d 1115, 1123 (Del. Ch. 1990) (directors' action deferring annual meeting, when no meeting date had been set and no proxies had been solicited, did "not impair or impede the effective exercise of the franchise"); MAI Basic Four, Inc. v. Prime Computer, Inc., C.A. No. 10868, 1989 Del. Ch. LEXIS 69, at *3 (Del.

uricich v. Emtrol Corp.,[296] the Delaware Supreme Court directed the Chancery Court to appoint a custodian to resolve a deadlock between two groups of fifty-percent stockholders.[297] The deadlock had the effect of perpetuating the defendant stockholder group's control of the company's board of directors.[298] The court thus concluded that a refusal to appoint a custodian "would, in effect, leave the existing directors in perpetual control of the corporate entity, and would relegate the one-half owners of the corporation to a perpetual minority status without remedy or recourse."[299]

Similarly, in *Blasius Industries v. Atlas Corp.*,[300] the court invalidated an attempt by the directors of Atlas Corporation to enlarge the size of their staggered board in response to a shareholder consent solicitation.[301] The board's action made it impossible for the insurgent shareholder to win control of the board even if supported by a majority of the company's stockholders.[302] Because the board acted (albeit in good faith) for the primary purpose of interfering with the effectiveness of a stockholder vote, the Chancellor ruled that the directors were required to demonstrate a "compelling justification" for their action.[303] The court emphasized that "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."[304] Consequently, the incumbent directors' attempt to undermine the democratic process could not be sustained.[305]

Ch. June 13, 1989) (upholding decision of board to postpone annual shareholders meeting to allow shareholders time to evaluate new tender offer and to afford directors a reasonable time to pursue alternative transaction).

296. 449 A.2d 232 (Del. 1982).

297. *Id.* at 240.

298. *Id.*

299. *Id.*

300. 564 A.2d 651 (Del. Ch. 1988).

301. *Id.* at 652.

302. *Id.* at 654-55.

303. *Id.* at 661. The court observed:

> The only justification that can, in such a situation, be offered for the action taken is that the board knows better than do the shareholders what is in the corporation's best interest. While that premise is no doubt true for any number of matters, it is irrelevant . . . when the question is who should comprise the board of directors.

Id. at 663. *See also* Aprahamian v. HBO & Co., 531 A.2d 1204, 1207 (Del. Ch. 1987) ("The business judgment rule . . . does not confer any presumption of propriety on the acts of the directors in postponing the annual meeting.").

304. *Blasius*, 564 A.2d at 659.

305. *Id.* at 662-63. In Stroud v. Grace, 606 A.2d 75 (Del. 1992), the court held that a board's fiduciary duty of disclosure did not require the directors of a privately held company to issue a detailed proxy statement in connection with an annual meeting for which proxies were not solicited. *Id.* at 87. Significantly, the court emphasized in *Stroud* that the

In sum, Delaware courts have applied heightened scrutiny to invalidate inequitable board action that interferes with the shareholders' ability to vote their shares effectively in the context of a specific shareholder vote and in a manner commensurate with the extent of their holdings.[306] A majority shareholder's power to exercise control by voting its lawfully acquired shares does not constitute a legally cognizable injury to, or interference with, the voting rights of the minority. As the Delaware Supreme Court observed under analogous circumstances in *Stroud v. Grace*: "The shareholders overwhelmingly rejected Stroud's nominees. That is not an injury. It is a reality flow-

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voting rights cases applying "stringent standards of review" invariably have involved a purposeful attempt to deprive shareholders of their existing voting power in the context of a specific shareholder vote. The court thus observed:

> Almost all of the post-*Schnell* decisions involved situations where boards of directors deliberately employed various legal strategies either to frustrate or completely disenfranchise a shareholder vote. As *Blasius* recognized, in those circumstances, board action was intended to thwart free exercise of the franchise. There can be no dispute that such conduct violates Delaware law.

Id. at 91.

In Centaur Partners, IV v. National Intergroup, Inc., 582 A.2d 923 (Del. 1990), the court affirmed a Chancery Court ruling that an 80% super-majority vote requirement in a corporation's charter was clear and unambiguous and therefore effective to override "the fundamental principle of majority rule." *Id.* at 927. In keeping with Delaware's "'general policy against disenfranchisement,'" the court in *Centaur Partners* emphasized that "high vote requirements which purport to protect minority shareholders by disenfranchising the majority, must be clear and unambiguous." *Id. Centaur Partners* thus can be read as a strong affirmation of the power of the majority to act in a manner contrary to the will of the minority in the absence of a "clear and unambiguous" agreement to the contrary. This willingness by the Delaware courts to uphold a majority stockholder's voting power also finds expression in the following discussion in Bershad v. Curtiss-Wright Corp., 535 A.2d 840 (Del. 1987):

> Stockholders in Delaware corporations have a right to control and vote their shares in their own interest. They are limited only by any fiduciary duty owed to other stockholders .... Clearly, a stockholder is under no duty to sell its holdings in a corporation, even if it is a majority shareholder, merely because the sale would profit the minority.

Id. at 845.

306. Chancellor Allen succinctly summarized this position in Stahl v. Apple Bancorp, 579 A.2d 1115 (Del. Ch. 1990):

> In each of these franchise cases the effect of the board action—to advance (*Schnell*) or defer (*Aprahamian*) a meeting; to adopt a bylaw (*Lerman*); or to fill board vacancies (*Blasius*)—was practically to preclude effective stockholder action (*Schnell*, *Blasius*, *Lerman*) or to snatch victory from an insurgent slate on the eve of the noticed meeting (*Aprahamian*).

Id. at 1123; *see also* Comment, Blasius Indus., Inc. v. Atlas Corp.: *Closer Scrutiny of Board Decisions Under the "Compelling Justification" Standard*, 16 DEL. J. CORP. L. 639, 663 (1991) ("[I]n evaluating the board's conduct the courts have employed closer judicial scrutiny when directors use their statutory authority to restrict the ability of the shareholders to replace them.") (footnote omitted).

ing from a proper turning of the wheels of corporate democracy . . . ."[307] Thus, a board's decision to approve a change of control should not be deemed an interference with or impairment of the voting rights of the company's stockholders. If someone purchases, for value, sufficient shares to acquire majority ownership of a company, Delaware law vigilantly enforces the right of the majority shareholder to exercise control.[308]

It is true that the voting rights cases define a unique area in which director action does not fall within the protection of the business judgment rule.[309] However, as the Chancellor noted in *Blasius*, the reason for this exception is that the "shareholder franchise is the ideological underpinning" for the exercise of directorial power and thus "in-

307. *Stroud*, 606 A.2d at 96. *See also Bershad*, 535 A.2d at 845 (emphasizing the right of a majority stockholder to control and vote its shares and to use its majority ownership to thwart any effort by directors to auction the company).

308. *See, e.g., Centaur Partners*, 582 A.2d at 927; *Bershad*, 535 A.2d at 845; *cf.* Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984) ("[I]t is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director."). As the *Paramount* court also noted, the majority stockholder owes fiduciary duties to the minority in that circumstance. Paramount Communications v. QVC Network, 637 A.2d 34, 43 (Del. 1994). The court nevertheless suggested that the protection of such fiduciary duties is cold comfort to shareholders who find themselves in the minority and, thus, unable to influence corporate direction through the ballot. *Id.* at 43. Unfortunately, the court did not elaborate on why it regarded the imposition of fiduciary duties on the majority stockholder as insufficient protection for the minority in this circumstance. For example, any interested or self-dealing transaction would require the majority stockholder to demonstrate its "utmost good faith and the most scrupulous inherent fairness of the bargain" in a manner "sufficient to pass the test of careful scrutiny by the courts." Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); *see also* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985).

In an arm's-length transaction, the majority stockholder would have every incentive to get the best possible deal for the corporation and its shareholders because the majority stockholder would have more at stake than any other investor in the company. *See, e.g., In re* Budget Rent-A-Car Corp. Shareholders Litig., C.A. No. 10418, 1991 Del. Ch. LEXIS 29, at *12 (Del. Ch. Mar. 15, 1991) (in the merger transaction, "Fulcrum and its affiliates received . . . $140 million for their 4.6 million shares [comprising 52%] of Budget stock . . . . [T]here can be no question but that Fulcrum's interest was in obtaining the highest possible price for its stock . . . ."); *In re* Mobile Communications Corp. of Am., C.A. No. 10627, 1990 Del. Ch. LEXIS 4, at *28 (Del. Ch. Jan. 7, 1991) (in considering class action settlement, court noted that directors' substantial stock holdings "created powerful economic . . . incentives to get the best available deal in the sale of [the company]"), *aff'd mem.*, 608 A.2d 729 (Del. 1992); Rosman v. Shoe-Town, C.A. No. 9483, 1988 Del. Ch. LEXIS 5, at *4-5 (Del. Ch. Jan. 18, 1988) ("The economic interest of American Express, as a [10%] stockholder who will likely tender and receive the $9.75 tender price, is the same as the other stockholders. . . . [I]ts economic interest in obtaining the maximum price is not in conflict with the interests of the other stockholders . . . .").

309. *See, e.g., Blasius*, 564 A.2d at 663; Aprahamian v. HBO & Co., 531 A.2d 1204, 1206-07 (Del. Ch. 1987).

volve[s] consideration[s] not present in any other context in which directors exercise delegated power."[310]

The Paramount board's action did not implicate this unique arena of the shareholder franchise. The board's decision to approve the transaction with Viacom neither impeded nor interfered with the ability of the company's then-existing stockholders to decide who should comprise the company's board of directors. Rather, pursuant to the board's mandate to manage the company's "business and affairs,"[311] the directors approved a transaction they asserted was in the shareholders' best interest. The directors' good faith, care, and loyalty therefore remained relevant considerations. Consequently, evidence of gross negligence, disloyalty, or disparate treatment of competing bidders should have been required before the business judgment rule's threshold presumptions of propriety were displaced.

(2) The Unimportance of Being Earnest—Enhanced Scrutiny Based on Transaction "Significance"

The *Paramount* court's critical pronouncement that enhanced scrutiny will apply in all change-of-control transactions represents an unwarranted expansion of the role of the courts in the context of corporate takeovers.[312] The court could have applied enhanced scrutiny based on the principles of *Unocal*[313] or *Macmillan*, given the Paramount directors' decisions (i) to adopt and rely on defensive measures (like the Stock Option Agreement and poison pill) and (ii) to treat Viacom and QVC unequally as competing bidders. Instead, the *Paramount* court announced that enhanced scrutiny will be required for all takeover transactions—including, apparently, those cases in which an independent and well-informed board has striven earnestly, in good faith, and even-handedly to seek the best transaction available.

310. *Blasius*, 564 A.2d at 659. *See also id.* at 663 (court will not defer to action of directors foreclosing shareholder vote on question of who shall comprise the board of directors).

311. DEL. CODE ANN. tit. 8, § 141(a) (1991).

312. The *Paramount* court plainly considered its transaction significance rationale as a more fundamental and all-encompassing justification for enhanced scrutiny than its concern for the "diminution" of shareholders' voting power. The court's emphasis on the significance of a change-of-control transaction pervades the *Paramount* opinion. *See supra* note 273. Moreover, while every takeover is "significant," the diminution-of-voting-power analysis obviously could apply only to a limited universe of takeovers—*i.e.*, those in which public stockholders are left in a minority position after consummation of the transaction.

313. It is true that the *Paramount* court cited *Unocal* as independent grounds for enhanced scrutiny. *See* Paramount Communications v. QVC Network, 637 A.2d 34, 36, 42, 49 (Del. 1994). The court emphasized, however, that a change of control independently will trigger enhanced scrutiny. *See infra* note 320.

a. A Departure from the Historical Framework

Paramount's transaction-significance rationale represents a substantial departure from Delaware's traditional model of corporate governance, including the model that had emerged in the decade since *Unocal.* Under the framework existing before *Paramount*, directors received the protection of the business judgment rule for facially-valid board action unless the threshold evidence showed (i) a breach of the directors' duties of care or loyalty[314] or (ii) suspicion-triggering conduct—*i.e.*, "specter"-raising conduct—on the part of the board (such as the deployment of antitakeover measures or the disparate treatment of competing bidders).[315] When no such showing is made, the courts typically defer to the directors' good faith efforts to pursue the shareholders' best interests. Now, even when there is no reason to question the board's effectiveness or motives, the courts evidently will apply enhanced scrutiny in every takeover transaction solely because such transactions are significant.[316]

The *Paramount* court's emphasis on transaction significance as a justification for enhanced scrutiny in all takeover cases alters this established framework by shifting the court's threshold focus away from the composition of the board and its deliberative processes to the nature of the transaction in question. It is true that a change-of-control transaction represents a highly significant event for a corporation and its shareholders. And as the court repeatedly emphasized in *Paramount*, a board's decision to commit to such a transaction represents a potentially unrecoverable opportunity for the shareholders to realize a value-maximizing premium for their shares.[317] Given these important considerations, the *Paramount* court sensibly concluded that di-

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314. *See supra* Part I.B.

315. *See supra* Parts II.A, II.B(1), II.C, and III.

316. In the non-takeover realm, the courts generally defer to a board's business judgment unless there is evidence that the board has been grossly negligent or disloyal. *See supra* Part I. In the takeover arena, the customary presumptions of the business judgment rule are suspended provisionally at the threshold if the directors have engaged in conduct that provides reasonable grounds to question their motives. *See supra* Parts II and III. Such conduct by the board can include adopting defensive measures to thwart a takeover or treating competing bidders unequally where the board has embraced a change-of-control transaction. *Id.*

317. *E.g.*, *Paramount*, 637 A.2d at 43 ("[T]he current Paramount stockholders will have no leverage in the future to demand another control premium."); *id.* at 44 ("[T]he selection of one alternative may permanently foreclose other opportunities."); *id.* at 45 ("[A]n asset belonging to public stockholders (a control premium) is being sold and may never be available again."); *id.* at 47-48 ("[A] sale of control . . . . represents a fundamental (and perhaps irrevocable) change in the nature of the corporate enterprise from a practical standpoint.").

rectors in such circumstances come under a *Revlon* duty to seek the best value reasonably available.[318] A fundamental question remains, however, regarding the appropriate level of judicial review once it is determined that *Revlon* applies.

The *Paramount* court appeared to blur this distinction—between when *Revlon* duties arise and the role of the court in a "*Revlon*" case—into a one-step analysis in which enhanced scrutiny automatically follows once *Revlon* is found to apply. This "A equals B equals C" analysis can be seen clearly in the following excerpt from the *Paramount* opinion:

> The consequences of a sale of control impose special obligations on the directors of a corporation. In particular, they have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders. The courts will apply enhanced scrutiny to ensure that the directors have acted reasonably.[319]

The absence of any meaningful analysis on the important doctrinal question of judicial review likely followed from the court's view that enhanced scrutiny has been required in this context ever since *Revlon* was first decided.[320] *Revlon*, of course, was not especially clear regarding whether such scrutiny applied to all takeover transactions or only to a board's decision to adopt antitakeover measures.[321] Mean-

318. *Id.* at 43, 46-48.

319. *Id.* at 43 (footnote omitted); *see also id.* at 47-48 (requiring "close scrutiny of board action" in takeover setting because "[t]here are few events that have a more significant impact on the stockholders than a sale of control or a corporate break-up.").

320. *Id.* at 36 ("[T]he sale of control in this case . . . implicates enhanced judicial scrutiny of the conduct of the Paramount Board under *Unocal* . . . and *Revlon* . . . ."); *id.* at 42 ("The decisions of this Court have clearly established the circumstances where such enhanced scrutiny will be applied. *E.g.*, *Unocal* . . . *Revlon* . . . ."); *id.* at 51 ("We decide only the case before us—a case which, on its facts, is clearly controlled by established Delaware law. Here, the proposed change of control and the implications thereof were crystal clear."); *see also* Paramount Communications v. QVC Network, Nos. 427, 1993 & 428, 1993 (Del. Dec. 9, 1993) (order) ("The traditional business judgment rule was not applicable, however, to decisions made by the Paramount defendants . . . since Paramount's strategic alliance with Viacom was predicated upon a sale of control to Redstone."); *id.* ("The change of control feature and the defensive aspects of the Paramount-Viacom transaction, *each independently*, subjected the directors' decision-making to enhanced scrutiny to determine reasonableness.") (emphasis added).

321. *Compare* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180-81 (Del. 1986) (applying *Unocal* analysis to uphold defensive measures) *with id.* at 182 (applying what appeared to be a conventional duty of loyalty analysis to invalidate asset lock-up); *see also* Gilson & Kraakman, *supra* note 81, at 252-53 (suggesting that *Revlon* applied a traditional duty of loyalty analysis instead of *Unocal*'s proportionality test to enjoin asset lock-up granted to favored bidder). Indeed, in the first few years after *Revlon*, the Chancery Court did not interpret the decision as requiring enhanced scrutiny of a board's decision to approve a sale of control. *See supra* Part II.C(2).

while, *Macmillan* seemed to suggest that there had always been enhanced scrutiny in the *Revlon* context, but "only" when directors treated competing bidders unequally.[322] *Paramount* now says that enhanced scrutiny is required in all takeovers, not because of "specters" or suspicions about directors' motives, but because of the significance of such transactions.[323]

In all events, the proposition that *Revlon* (or *Macmillan*, for that matter) announced enhanced scrutiny for all change-of-control transactions certainly is debatable. The more important point is that no Delaware court meaningfully has examined why such scrutiny is necessary in every takeover, even those in which there is no reason to question (i) the bona fides of the directors (as would be the case when directors treat competing bidders unequally or act in some other suspicious manner) or (ii) the directors' ability to function properly under the circumstances (*i.e.*, free of any conflicting personal interest or other destabilizing influence). *Revlon* and *Macmillan* both involved egregious examples of boards playing favorites among competing bidders at the ultimate expense of their shareholders.[324] Both cited *Unocal*'s "omnipresent specter" rationale,[325] and neither purported to identify an entire category of business decisions—*i.e.*, those

322. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1989). In *Macmillan*, the court suggested that *Unocal*'s principles of enhanced scrutiny "pervade[ ]" *Revlon*. *Id.* at 1287. Thus, *Macmillan* certainly could be read as requiring enhanced scrutiny in all corporate takeovers. A more logical reading of *Macmillan*, given its reliance on *Unocal*'s "omnipresent specter" rationale, is that enhanced scrutiny *may* be triggered in the *Revlon* context but "only" if the directors arouse suspicion about their motives by treating competing bidders unequally. *Id.* at 1288. *See also* Paramount Communications v. Time, Inc., 571 A.2d 1140, 1151 n.14 (Del. 1990) ("Within the auction process, any action taken by the board must be reasonably related to the threat posed or reasonable in relation to the advantage sought. . . . Thus, a *Unocal* analysis *may* be appropriate when a corporation is in a *Revlon* situation . . . .") (emphasis added) (citing *Macmillan*, 559 A.2d at 1288). Moreover, to the extent *Revlon* applied *Unocal* in the auction context, it did so to invalidate the board's favored treatment of one of two competing bidders. *See Revlon*, 506 A.2d at 184 ("[W]hen bidders make relatively similar offers . . . the directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions.").

323. *Paramount*, 637 A.2d at 47-48; *see also id.* at 43-45. Indeed, the only noteworthy reference to considerations of motive in *Paramount* reveals the court's continuing trust and confidence in outside directors to do what is best for shareholders. The court thus emphasized that "the role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management may not necessarily be impartial." *Id.* at 44 (citing *Macmillan*, 559 A.2d at 1285). *But see* Mirvis, *supra* note 200, at 63 (arguing that a change of control "implicate[s] the 'omnipresent specter' of potential director self-interest . . . . It may be that, after all, there never was a *Revlon* land. There is only a *Unocal* universe").

324. *See Revlon*, 506 A.2d at 184; *Macmillan*, 559 A.2d at 1281-83.

325. *Revlon*, 506 A.2d at 180; *Macmillan*, 559 A.2d at 1287.

involving a sale or change-of-control transaction—that automatically fails to qualify for traditional business judgment rule review because of the importance of such decisions.

Although the *Paramount* court described its holding as "clearly controlled by established Delaware law,"[326] the court did not explain why it had discarded the "omnipresent specter" rationale on which *Macmillan* and virtually every other "enhanced scrutiny" takeover case relied.[327] Nor did the court attempt to identify some other destabilizing influence under which directors are perceived to labor in the takeover context so that the customary presumptions of the business judgment rule should be suspended.[328] The *Paramount* court essentially made a policy judgment that, when a company is being sold, shareholders simply have too much at stake for courts to accord deference to the board's decisions. Consequently, the court created a role for itself as the arbiter of reasonableness for board decisions falling within this special category of transactions.

326. *Paramount*, 637 A.2d at 51 ("[T]he case before us . . . is clearly controlled by established Delaware law. Here, the proposed change of control and the implications thereof were crystal clear."). Indeed, the court introduced its legal discussion with the heading: "APPLICABLE LEGAL PRINCIPLES OF ESTABLISHED DELAWARE LAW"). *Id.* at 41.

327. *See supra* Part III.

328. *See generally supra* Part I.B. It is also questionable why the *Paramount* court perceived a need to institute a layer of judicial review to "ensure" a "reasonable" result in every takeover. *Id.* at 43, 45. There was no track record of unremedied dereliction by boards in this context that might have prompted such a sweeping reformulation of the enhanced scrutiny test. For example, the directors' various breaches of their duties of loyalty and care in *Macmillan* triggered an entire fairness analysis. *Macmillan*, 559 A.2d at 1265, 1279. Similarly, in *Cede*, the directors' apparently uninformed approval of a merger transaction prompted an entire fairness analysis. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 366-67 (Del. 1993). Curiously, although *Cede* (a case plainly involving a change of control) was decided some seven weeks before the Delaware Supreme Court's bench ruling in *Paramount*, the *Cede* court barely hinted at the requirement of enhanced scrutiny for all takeovers that the *Paramount* court apparently regarded as well-established. *See Cede*, 634 A.2d at 361 ("In the review of a transaction involving a sale of a company, the directors have the burden of establishing that the price offered was the highest value reasonably available under the circumstances.").

In *Paramount*, the favored treatment that Viacom received (including the Stock Option Agreement, the Termination Fee Agreement, and the No-Shop provisions) could have triggered enhanced scrutiny under *Macmillan*'s specific test for reasonableness once such disparate treatment had been shown. *See Macmillan*, 559 A.2d at 1288 (holding that a board's action in treating competing bidders differently "must be reasonable in relation to the advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests") (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)). And if *Revlon* were decided today, the Revlon board's decision to "play favorites" also could be invalidated under *Macmillan*'s disparate treatment test. *See Revlon*, 506 A.2d at 184.

b. "Enterprise" Versus "Ownership" Decisions

Paramount is perhaps best explained as a case in which the distinction between "enterprise" issues and "ownership" issues was elevated to a doctrinal level. In his thoughtful 1985 article lamenting the Delaware Supreme Court's decision in *Van Gorkom*,[329] Bayless Manning predicted (accurately) that the courts eventually would differentiate between "enterprise" issues and "ownership" issues in terms of the vigor with which courts would review a board's business decisions.[330] As discussed below, it appears that the Delaware Supreme Court has embraced Manning's classifications as a tool for identifying board decisions that will trigger enhanced scrutiny.[331]

Manning suggested that "enterprise issues," such as a decision to expand or contract a company's particular line of business, are unlikely to receive "judicial Monday morning quarterbacking on a board's decision."[332] On the other hand, "ownership claim issues," *i.e.*, those which pertain directly to a shareholder's economic stake in the corporation, "are very close to a nerve" and thus could prompt a court to impose more stringent standards of care and loyalty on the directors.[333] As Manning remarked concerning transactions—such as the sale of a company—that involve "ownership" issues:

> [T]hose transactions hit [the shareholder] directly in his role as an "owner," not "owner of the corporation" as legal doctrine would have it, but owner of his reified piece of property, *his* share of stock. After centuries of a private-property culture, none of us reacts well to receipt of a letter saying, "This will inform you that I have just sold *your* house. Check is enclosed."[334]

The following year, then-practitioner Veasey (now Chief Justice and author of the *Paramount* decision) authored an article addressing the business judgment rule in the setting of takeover defenses in which he embraced Manning's enterprise/ownership analysis.[335] A few years later Veasey again cited Manning's analysis with approval in an article

329. Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1 (1985).

330. *Id.* at 6.

331. Chief Justice Veasey, author of the *Paramount* decision, previously authored articles as a practitioner in which he referred (explicitly or implicitly) with approval to Manning's analysis. *See infra* notes 335-337 and accompanying text.

332. Manning, *supra* note 329, at 5-6.

333. *Id.* at 6.

334. *Id.* at 5-6; *see also* Minstar Acquiring Corp. v. AMF Inc., 621 F. Supp. 1252, 1260 n.6 (S.D.N.Y. 1985) ("A board of directors' assertion of a unilateral right, under the business judgment rule, to act as a surrogate for the shareholder's independent right of alienation of his stock is troublesome.").

335. Veasey, *supra* note 24, at 505. As then-practitioner Veasey explained:

on the directors' duty of loyalty.[336] As Veasey the practitioner then explained, "the application of the business judgment rule may be shaped differently depending on whether the issue is an 'ownership' issue (one involving control or the equity interests of stockholders); or an 'enterprise' issue (one involving business strategy or operations)."[337]

More recently, in remarks delivered at an ABA symposium on "New Dynamics of Corporate Governance" (held one week before the Delaware Supreme Court issued its bench ruling in *Paramount*), Chief Justice Veasey identified the enterprise/ownership analysis as an inquiry which a court "must" undertake.[338] Subject to a disclaimer that his remarks were not intended to relate to the then-pending *Paramount* case,[339] Chief Justice Veasey observed: "In evaluating the facts of each given case, *the court must . . . consider* (a) how the directors behaved in the boardroom in making their decision, and (b) the entire

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> It is presumed that decisions of disinterested directors are made in good faith for a rational business purpose, with due care, and in the honest belief that they are acting in the best interests of stockholders. These decisions are often 'enterprise' or operational issues ('shall we buy a new truck?' or 'shall we give Mary a raise?'). In transactional justification cases such as defenses to takeovers, the issues revolve around stockholder ownership rights and values.

Id. (footnote omitted) (citing Manning, *supra* note 329).

336. E. Norman Veasey, *Duty of Loyalty*, *supra* note 89.

337. *Id.* at 2066 n.4 (citing Manning, *supra* note 329). In a book review authored later that same year, Veasey again alluded to this distinction between enterprise and ownership issues, identifying what he referred to as a "compartmentalized" category of jurisprudence involving "contests for control" in which the *Unocal* analysis is applied:

> To permit a court to determine the "reasonableness" of actions of business people or to substitute the court's judgment for that of the directors is anathema to those who would be reluctant to countenance any significant erosion in the business judgment rule. If, however, the limitations on the application of judicial review and burden-shifting of *Unocal* are clearly understood, judicial management of contests for control takes on a life and culture of its own, including a jurisprudence unique to control contests . . . . This jurisprudence may be appropriately compartmentalized so as not to be expanded unduly in allowing courts to substitute their judgment for that of the directors. Indeed, there seems to be a resistance, at least by Delaware courts, to expand the *Unocal* doctrine to other traditional business judgment rule applications such as statutory directorial prerogatives, purely enterprise decisions, directorial pecuniary liability . . . and in other areas.

Veasey, Book Review, *supra* note 86, at 577-78 (footnotes omitted).

338. E. Norman Veasey, *Professionalism and the Corporate Counselor*, Remarks of Chief Justice E. Norman Veasey at ABA Symposium, "New Dynamics of Corporate Governance," at 8-9 (Dec. 2, 1993).

339. *Id.* at 5-6.

factual setting including the nature of the corporate transaction which is implicated. (*Is it an 'enterprise' or an 'ownership' decision?*)"[340]

In his scholarly commentary on this subject, Professor Dooley similarly embraced Manning's analysis as a largely "useful" classification.[341] Significantly, Professor Dooley did not invoke Manning's enterprise/ownership dichotomy as a justification for a court's *substantive* review of the reasonableness of a board's decision, but rather as grounds for a closer look by the court at a board's deliberative *processes*. Professor Dooley thus explained Manning's analytical model as follows: "It is the 'check is enclosed' metaphor that best captures the limits of the 'ownership claim' issues where the court will be inclined to look closely at the informational processes of the board. Certainly, it describes precisely the most notorious 'process' case of our time, *Smith v. Van Gorkom*."[342] *Paramount*, of course, extends the analyses of Manning and Professor Dooley by requiring enhanced scrutiny of the reasonableness of *both* the process *and* the substance of a board's decisions in the context of a change of control.[343]

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340. *Id.* at 8-9 (emphasis added). In Nixon v. Blackwell, 626 A.2d 1366, 1378 (Del. 1993), the Delaware Supreme Court, in an opinion authored by Chief Justice Veasey, alluded to the greater deference accorded to decisions of a board that fall within the area of directors' business expertise. In language implicitly suggesting an "enterprise" issue analysis, the *Nixon* court observed:

> In a case where the court is scrutinizing the fairness of a self-interested corporate transaction the court should articulate the standards which it is applying in its scrutiny of the transactions . . . . While the court is not expected to substitute its business judgment for that of the directors in areas where particular business expertise is an ingredient of the decision, the reasonableness of the business judgment of the conflicted directors' decision must be examined searchingly through a principled and disciplined analysis.

Id. (footnote omitted). By implication, the court in *Nixon* suggested that it would be more comfortable assessing the wisdom of a board's decisions in a context where business expertise is not at the core of the board's decision, perhaps including larger decisions like a sale of control that directly and immediately affect the shareholders' ownership in the company.

341. Dooley, *supra* note 14, at 474 n.47.

342. *Id.* at 473 (footnote omitted); *but see* Pelto, *supra* note 24, at 848 ("The degree of deference given directors by a rule designed to give shareholders the benefit of superior management expertise is inappropriate when the decision involves the shareholder's own investment. The courts, therefore, should scrutinize directors' decisions that affect corporate ownership.").

343. Paramount Communications v. QVC Network, 637 A.2d 34, 36 (Del. 1994) ("We further hold that the conduct of the Paramount Board was not reasonable as to process or result."); *id.* at 45 ("[A]n enhanced scrutiny test involves a review of the reasonableness of the substantive merits of a board's actions."); *id.* ("courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.").

Foreshadowing *Paramount*'s emphasis on the irrevocable consequences of a change-of-control transaction,[344] Professor Dooley helpfully differentiated further between "ownership" decisions in which a board thwarts a takeover (and thus causes the corporation to remain independent) and "ownership" cases in which a board commits to a sale or change of control. As Professor Dooley explained, a decision by the board to prevent a sale and a decision to sell the company both significantly impact the shareholders as owners of the corporation.[345] Nevertheless, it is cases in this latter category, like *Van Gorkom*, that are more likely to invite judicial review because "the board decides to change irrevocably the nature of the shareholder's claim by selling the company for cash or securities of another firm."[346]

The foregoing analysis suggests a greater inclination by the courts to review carefully those decisions by boards that raise shareholder "ownership" issues. *Paramount* goes beyond the commentators' recognition of this practical reality—that courts will pay close attention to a board's deliberative processes in this context[347]—by instituting a layer of substantive judicial review as to the reasonableness of a board's decisions in every corporate takeover. The *Paramount* court's introduction of such substantive review thus exalts the enterprise/ownership analysis into a doctrinal litmus test for isolating a category

344. *See supra* notes 273-275 and accompanying text.

345. Dooley, *supra* note 14, at 474.

346. *Id.* at 475. As Professor Dooley explained:

> Perhaps what distinguishes the "check is enclosed" cases such as *Van Gorkom* is the finality of the event. Once the board decides to change irrevocably the nature of the shareholders' claim by selling the company for cash or securities of another firm, the value of the residual interest in the selling firm is fixed forever. There is no other remedy—not even the option of "turning the rascals out" by electing a new board, an option that remains open to the frustrated tender offeree.

Id.

347. In applying a traditional business judgment rule analysis to the sale of control in *In re* Fort Howard Corp. Shareholders Litig., C.A. No. 9991, 1988 Del. Ch. LEXIS 110 (Del. Ch. Aug. 8, 1988), Chancellor Allen sensibly suggested that the magnitude of such a transaction requires a greater undertaking by the board to make an informed decision:

> The more significant the subject matter of the decision, obviously, the greater will be the need to probe and consider alternatives. When the decision is to sell the company, or to engage in a recapitalization that will change control of the firm, the gravity of the transaction places a special burden upon the directors to make sure that they have a basis for an informed view.

Id. at *4-5; *see also id.* at *42 ("The need to exercise judgment is *inescapably* put on the board at points in an auction process and the validity of the exercise of that judgment is appropriately subjected to a business judgment form of judicial review."). The *Macmillan* court later criticized the Chancellor's failure to apply an enhanced scrutiny analysis in *Fort Howard*. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287-88 (Del. 1989).

of decisions in which the court will dislodge the authority of the board without regard to the directors' independence, care, or good faith.

c. Problems with *Paramount*'s Requirement of Substantive Review for All Takeovers

Whether *Paramount*'s rationale is described as one of transaction-significance or an enterprise/ownership analysis,[348] the decision's overly-broad requirement of enhanced scrutiny for every takeover transaction can be justified under neither *Unocal* (and its progeny) nor the principles underlying the business judgment rule.

i. The Unocal-Macmillan *Model*

Assuming one accepts *Unocal*'s premise that even outside directors face some "species of . . . interest"[349] in resisting an unsolicited takeover bid,[350] enhanced scrutiny is justified in such a setting because

348. Although the *Paramount* court did not explicitly adopt Manning's enterprise/ownership analytical model, the decision can readily be explained within Manning's "ownership issue" framework. Under prior precedent, the courts justified enhanced scrutiny in the takeover context based on the "omnipresent specter" of potential self-interest or some other perceived destabilizing influence upon the board. *See supra* Parts II.A and III. The *Paramount* court eschewed this analysis, relying instead on the significance of a sale of control transaction to the corporation's owners as justification for applying heightened scrutiny. Paramount Communications v. QVC Network, 637 A.2d 34, 42-43, 45, 47-48 (Del. 1994).

349. AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 115 (Del. Ch. 1986).

350. Tracing the source of the "omnipresent specter" is a more daunting task than it might appear at first blush. In coining the "omnipresent specter" phrase, the *Unocal* court relied on Bennett v. Propp, 187 A.2d 405 (Del. 1962), in which the court concluded that "directors are of necessity confronted with a conflict of interest" when they cause the corporation to repurchase its shares when a threat to control exists. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (quoting *Bennett*, 187 A.2d at 409). *Bennett*, however, did not separately analyze why outside directors should be deemed "conflicted" in such circumstances. The only authority on which the *Bennett* court relied for its conclusions was a law review note on the lower court's decision. *See* 187 A.2d at 409 (citing Note, *Board of Directors May Not Ratify Chairman's Purchase of Corporate Shares to Prevent Assumption of Control by Another Without Adequate Study of Threat to Corporation*, 62 COLUM. L. REV. 1096, 1100 (1962)). The author of the Note, meanwhile, opined in similarly conclusory terms that a board's objectivity is open to question in this context: "Certainly those in control have a personal interest in perpetuating their control." Note, *supra*, at 1100.

Despite the numerous cases after *Unocal* in which enhanced scrutiny was applied to assess the validity of various defensive measures, the courts never meaningfully developed or explained the potentially destabilizing influence that this "species of director interest" was thought to create. *See supra* Part II.B. Moreover, it is difficult to square the potential conflict of interest that outside directors are thought to face when confronting a takeover with the cases which hold that fees paid to outside directors do not constitute a legally cognizable interest. *E.g.,* Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988) (allegation that directors "are paid for their services as directors" does "not establish any financial interthere are threshold questions about the board's ability to function normally, *i.e.*, independently and disinterestedly. Similarly, the suspicions about directors' motives that arise when a board treats competing bidders unequally in an auction supplies the justification for enhanced scrutiny in the takeover context.[351] In this latter setting, the potential self-interest that outside directors are thought to confront when resisting a takeover is obviously not present. Nevertheless, when bidders receive unequal treatment, a red flag goes up because there is concern that the board, as auctioneer, may be improperly motivated—or unduly influenced by senior management—to steer the

est" for purposes of determining demand futility); Day v. Quotron Sys., Inc., C.A. No. 8502, Del. Ch. 1989 LEXIS 164, at *19-20 (Del. Ch. Nov. 20, 1989) ("Citicorp's stated intention to retain Quotron's directors and management following an acquisition does not render Quotron's outside directors 'interested' in this transaction by reason of their accepting normal directors' fees."); Lewis v. Straetz, C.A. No. 7859, slip op. at 12 (Del. Ch. Feb. 12, 1986) ("The mere fact that the directors are paid fees for their services as directors does not impugn their ability to act"); Moran v. Household Int'l, Inc., 490 A.2d 1059, 1074-75 (Del. Ch.) (the business judgment rule's "presumption of good faith is heightened" when "a majority of the directors are independent or outside directors receiving no income other than usual directors' fees . . . ."), *aff'd*, 500 A.2d 1346 (Del. 1985); Block et al., *supra* note 27, at 73 ("Allegations that the directors are paid for their services as directors, without more, do not establish a material financial interest") (footnote omitted). Yet there is some sense in the cases that even outside directors are thought to be "interested" (perhaps psychologically, if not financially) in preserving their control and that of the corporation's management. Judge Posner drove home this point well:

> When managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the takeover attempt succeeds, they have a clear conflict of interest, and it is not cured by vesting the power of decision in a board of directors in which insiders are a minority . . . . No one likes to be fired, whether he is just a director or also an officer. These so-called outsiders moreover are often friends of the insiders. And since they spend only part of their time on the affairs of the corporation, their knowledge of those affairs is much less than that of the insiders, to whom they are likely therefore to defer.

Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987). *See also* Panter v. Marshall Field & Co., 646 F.2d 271, 300 (7th Cir.) (Cudahy, J., concurring in part and dissenting in part) ("But the very idea that, if we cannot trace with precision a mighty flow of dollars into the pockets of each of the outside directors, these directors are necessarily disinterested arbiters of the stockholders' destiny, is appallingly naive."), *cert. denied*, 454 U.S. 1092 (1981); Prentice & Langmore, *supra* note 85, at 473 (outside directors' "economic and psychological ties" with management can create a circumstance in which "outside directors cannot easily stand up to the insiders even if they wish to do so").

351. Under a more sensible "narrow" reading of *Macmillan* (*see supra* Part III.A(2)), enhanced scrutiny should be applied to a board's decision to treat competing bidders unequally because such conduct raises a threshold question about the directors' motivations. *Macmillan*, 559 A.2d at 1287-88 (citing *Unocal*'s "omnipresent specter" of potential self-interest and formulating enhanced scrutiny test for disparate treatment of competing bidders).

transaction to a bidder perceived as friendly to management, instead of resolutely seeking the best available price from all comers.[352]

Paramount's sweeping requirement of enhanced scrutiny for every transaction in which a board agrees to a takeover cannot be justified within this established framework. If a board approves a change-of-control transaction in a setting in which all suitors are treated evenhandedly, why should the court act as the objective arbiter of reasonableness? Absent disparate treatment of competing bidders (or some other suspicion-triggering conduct), there is no specter of potential self-interest or improperly motivated board action to justify enhanced scrutiny.

ii. Business Judgment Rule Concerns

Paramount's transaction-significance rationale essentially reflects a policy judgment that the court must ensure reasonableness in all takeovers because of the importance of such transactions to the corporation's owners.[353] This judicially-imposed requirement is problematic, however, because it runs afoul of the principles underlying the business judgment rule. As shown below, the reasons for deference are as compelling in this setting—assuming there is no disparate treatment or other suspicion-triggering conduct—as in the context of more routine enterprise decisions.

As shown earlier, the courts' professed lack of competency in business matters has been discredited as a justification for deference under the business judgment rule.[354] Nevertheless, the Delaware Supreme Court gave credence to this rationale relatively recently in *Nixon v. Blackwell*.[355] One could surmise therefore that the court's competency concerns, if any, would be far less acute, and therefore

352. *Revlon* addressed this precise concern by emphasizing that directors "cannot fulfill their 'enhanced' *Unocal* duties by playing favorites with the contending factions" when competing "bidders make relatively similar offers . . . ." Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986). In Roberts v. General Instrument Corp., C.A. No. 11639, 1989 Del. Ch. LEXIS 138 (Del. Ch. Aug. 13, 1990), Chancellor Allen also alluded to this concern by noting the potential for senior management to attempt to influence negotiations for selfish reasons: "The first question . . . is whether this transaction is . . . a bargain reached at arm's length . . . or whether it is a transaction in which a senior management, hopeful of participating with the buyer in the future ownership of the enterprise, affected negotiations by assisting the buyer to the shareholders detriment." *Id.* at *25-26.

353. Paramount Communications v. QVC Network, 637 A.2d 34, 43 (Del. 1994).

354. *See supra* notes 31-33 and accompanying text.

355. 626 A.2d 1366, 1378 n.14 (Del. 1993) ("[C]ourts are 'ill-equipped' to make business decisions.") (quoting Auerbach v. Bennett, 419 N.Y.S.2d 920, 926-28 (N.Y. 1979)).

less of a perceived barrier to judicial review, when the business at hand involves the directors' narrowly-focused obligation to seek the best available transaction.[356] Combining this fact with the perceived "rare situations"[357] in which *Paramount*'s enhanced scrutiny test will be "compartmentalized,"[358] may explain the court's willingness to craft a larger role for itself in this context.

But these reasons are unpersuasive. *Paramount* specifically refers to the deference of the business judgment rule in terms of the board's managerial authority, not the court's purported lack of expertise in business matters.[359] Moreover, as noted earlier,[360] practitioner Veasey, later Chief Justice and author of *Paramount*, co-authored an article disparaging the competency rationale as "nearly indefensible."[361] It is therefore unlikely that *Paramount*'s imposition of heightened scrutiny on all takeovers was attributable to competency concerns. Instead, *Paramount* displaced the board's managerial authority because of the significance of takeovers to the shareholders and the "ownership" issues that such transactions present.[362]

The problem with *Paramount*, however, is that the generally accepted reasons for deference under the business judgment rule have continuing and vital application in the takeover setting notwithstanding the importance of a takeover transaction to the corporation's shareholders. Specifically, deference is appropriate in the takeover context because it will benefit shareholders (i) by encouraging risk-taking by the board in structuring and negotiating a transaction without the disruptive and destabilizing prospect of substantive judicial review and (ii) by upholding the directors' managerial authority and thereby strengthening the board's negotiating position in pursuing the best available transaction.

356. *Paramount*, 637 A.2d at 44 ("In the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders—and they must exercise their fiduciary duties to further that end."); *cf.* Easterbrook & Fischell, *supra* note 35, at 1161-98 (arguing that shareholders are as well-equipped as managers to decide whether to accept or reject a tender offer because "[t]he decision does not involve management of a corporation's affairs in any meaningful sense").

357. *Paramount*, 637 A.2d at 42.

358. Veasey, Book Review, *supra* note 86, at 577.

359. *Paramount*, 637 A.2d at 41-42, 45 n.17; *but see id.* at 45 ("The board of directors is the corporate decision-making body best equipped to make these judgments.").

360. *See supra* note 32 and accompanying text.

361. Dooley & Veasey, *supra* note 32, at 521.

362. *See supra* Parts IV.B(1) and IV.C(2)(b).

A board's decisions in the context of a change-of-control transaction may not involve such purely entrepreneurial matters as product development and marketing strategies. There are plenty of risks to be weighed and judgments to be made, however, when a board places a corporation on the auction block. Such judgments of course must be made in good faith, with appropriate information and care, and with the singular goal of obtaining the best available transaction for the shareholders. But the directors also need to make these judgments without the destabilizing prospect that the courts will unfairly second-guess their decisions with the benefit of after-acquired information.

Directors will be required to exercise judgment at any number of points in the auction process.[363] For example, in *RJR Nabisco*, the special committee accepted KKR's offer over the management group's substantially equivalent bid because it was late in the game and the committee's advisors feared they were perilously close to "overtrading [the] transaction with KKR and . . . losing them as a bidder."[364] In *Citron*, the Fairchild board accepted Schlumberger's "take-it-or-leave-it, $66 that day" offer (instead of Gould's higher but less certain $70 offer) when, unbeknownst to the Fairchild directors, Schlumberger's board also had authorized a bid as high as $70 per share.[365] Such judgments do not readily lend themselves to substantive after-the-fact review by the courts, but that is what *Paramount* now requires.

Even the apparently simple act of setting an auction deadline can involve issues of judgment and strategy.[366] Moreover, as Vice Chan-

363. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287 (Del. 1989) ("We recognize that the conduct of a corporate auction is a complex undertaking both in its design and execution."); *see also In re* RJR Nabisco, Inc. Shareholders Litig., C.A. No. 10389, 1989 Del. Ch. LEXIS 9, at *58 (Del. Ch. Jan. 31, revised Feb. 14, 1989) (describing the difficult risk/benefit calculations inherent in negotiating with multiple bidders); *In re* Fort Howard Corp. Shareholders Litig., C.A. No. 9991, 1988 Del. Ch. LEXIS 110, at *42 (Del. Ch. Aug. 8, 1988) ("The need to exercise judgment is *inescapably* put on the board at points in an auction process . . . .").

364. *RJR Nabisco*, 1989 Del. Ch. LEXIS 9, at *52; *see also* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 68 (Del. 1989) ("Fairchild's board came under no legal duty to give Gould one more opportunity to submit a firm unconditional bid and risk losing the Schlumberger offer.").

365. *Citron*, 569 A.2d at 62 & n.12; *see also In re* Sea-Land Corp. Shareholders Litig., C.A. No. 8453, 1993 Del. Ch. LEXIS 49, at *46 (Del. Ch. Mar. 19, revised Mar. 26, 1993) (upholding decision by Sea-Land board, when confronted with "a firm—and extremely short—deadline," to accept CSX Corporation's acquisition proposal at $28 per share, despite evidence showing that CSX board had authorized bid up to $32 per share), *aff'd mem.*, 633 A.2d 371 (Del. 1993).

366. The recent battle for control of Grumman Corp. provides a prime example. On March 7, 1994, it was announced that Martin Marietta Corp. and Grumman had agreed to

cellor Jacobs explained in *Paramount* before the case reached the Supreme Court, even competing all-cash bids can require a complex judgment by the board based on a number of subjective variables.[367] In this regard, it is also worth recalling the Delaware Supreme Court's admonition in *Time-Warner* that the court, in applying *Unocal*'s enhanced scrutiny, should not "substitut[e] its judgment as to what is a 'better' deal for that of a corporation's board of directors."[368] *Paramount* now invites precisely this sort of judicial meddling.

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a friendly merger transaction in which Martin Marietta would pay Grumman stockholders $55 per share, or approximately $1.93 billion, to acquire the company. Three days later, Northrop Corp. offered to acquire Grumman for $60 per share, or $2.04 billion. On March 28, Grumman announced that it would hold an auction, open to all bidders, with a deadline of March 31. *See Mergers and Acquisitions; Northrop Wins Battle for Grumman*, Facts on File World News Digest, Apr. 7, 1994, at 244. Faced with offers from two interested bidders, Grumman established a short auction deadline to avoid a prolonged bidding war and the risk of "disruption to the company's business and . . . uncertainty among the company's constituencies." Roy J. Harris, Jr., *Grumman Stock Falls 2.3% Reflecting Uncertainty of Higher Bids in Auction*, WALL ST. J., Mar. 30, 1994, at A4.

Northrop complained that the short auction deadline would hurt Grumman stockholders by "prematurely cut[ting] off potential bidding." *Id.* Northrop also objected to Grumman's proposed sealed auction procedure because its $60 per share offer was already $5 per share higher than Martin Marietta's bid. James F. Peltz, *Grumman Cooled to Northrop's Revised Bid for Takeover*, L.A. TIMES, Mar. 31, 1994, at D1. Nevertheless, Grumman held fast to its auction procedures and Northrop submitted an increased bid of $62 per share, some $70 million more than its initial $60 per share offer. Martin Marietta, meanwhile, declined to increase its initial offer of $55 per share. Roy J. Harris, Jr., *Northrop Offer of $2.17 Billion Wins Grumman*, WALL ST. J., Apr. 5, 1994, at A3.

367. As the Vice Chancellor observed:

> Although "enhanced scrutiny" must be satisfied before business judgment rule presumptions will apply, that does not displace the use of business judgment in the board room. A determination of which of two transactions is the better one for the shareholders requires the directors to exercise business judgment based on adequate information. Ordinarily, as between two competing all cash offers, the board will be required to choose the higher one, but even that is not always the case if the higher offer is subject to uncertainties that create a significant risk of nonconsummation. And where, as here, the competing transactions involve stock as part of the consideration, the valuation of that component requires business judgment as well.

QVC Network v. Paramount Communications, 635 A.2d 1245, 1268 (Del. Ch.), *aff'd*, 637 A.2d 34 (Del. 1994). *See also Fort Howard*, 1988 Del. Ch. LEXIS 110, at *41-42 ("Even in the auction context, if one deal is all cash and more likely to close and sooner, a disinterested board might prefer it to a deal that may be thought to represent a somewhat higher price, but is not all cash and not capable of closing as quickly.") (citing Citron v. Fairchild Camera & Instrument Corp., C.A. No. 6085 1988 Del. Ch. LEXIS 67 (Del. Ch. May 19, 1988), *aff'd*, 569 A.2d 53 (Del. 1989)); *but see* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1288 (Del. 1989) ("The latitude a board will have in responding to differing bids will vary according to the degree of benefit or detriment to the shareholders' general interests that the amount or terms of the bids pose.").

368. Paramount Communications v. Time, Inc., 571 A.2d 1140, 1153 (Del. 1990). In its *Unocal* analysis, the *Time-Warner* court rejected the plaintiffs' assertions that the only con-

The chilling threat of substantive judicial review in every takeover will loom as a potentially destabilizing and counterproductive influence upon a board's efforts to fashion an auction and negotiation strategy for pursuing the best available transaction for the shareholders. To be sure, *Paramount* contains various disclaimers that "a court should not second-guess" a board's decision in this context "even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination."[369] The problem with this analysis is that any substantive review for reasonableness will necessarily create far more uncertainty and instability than a more deferential process-based analysis.[370] Such substantive review also will undermine the board's authority as centralized decisionmaker.

The deference of the business judgment rule is intended to promote and uphold the board's managerial authority as a "centralized decisionmak[er]"[371] for the firm.[372] The predictability, stability and enhanced negotiating power that result from upholding the board's managerial authority would seem as vital (if not more so) in the setting of an auction or negotiation for sale of control as in the context of routine "enterprise" decisions.[373] Yet, without requiring any showing

ceivable threat posed by an all-cash offer is inadequate value: "Plaintiffs' position represents a fundamental misconception of our standard of review under *Unocal* principally because it would involve the court in substituting its judgment as to what is a 'better' deal for that of a corporation's board of directors." *Id.* at 1153.

369. Paramount Communications v. QVC Network, 637 A.2d 34, 45 (Del. 1994).

370. Interestingly, the *Cede* court criticized as "unhelpful" and "confusing" the Chancellor's formulation of a "reasonable person standard for determining the materiality of a given director's self-interest in a challenged corporate transaction." Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 364 (Del. 1993); *see also id.* at 364 n.31 ("The reasonable person standard lacks precision.").

371. Dooley & Veasey, *supra* note 32, at 522.

372. *See supra* notes 38-43 and accompanying text.

373. *See Lowenstein, supra* note 81, at 267 (noting the "substantial risk that the shareholders . . . will . . . accept an offer that as a group they would otherwise have chosen to reject, or that they may accept an offer at a price a good deal lower than the one they might have received in a negotiated transaction or auction"); Dale A. Oesterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53, 57-58 (1985) ("Conscientious managers of a target company may be able to negotiate with the initial [tender] offeror and other potential bidders to extract gains for the shareholders that shareholders would not realize if they responded individually.") (footnote omitted); Prentice & Langmore, *supra* note 85, at 445-47 (arguing for the authority of a board to "just say no" in the context of an auction if bidding fails to reach an adequate level, so that "target boards should be able to bargain on behalf of target shareholders to obtain as large a premium as possible"); *cf.* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1119 (Del. 1994) ("'The power to say no is a significant power. It is the duty of directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders . . . .'") (quoting *In re* First Boston, Inc. Shareholders Litig., C.A. No. 10338, slip op. at 15-16 (Del. Ch. June 7, 1990)).

of disparate treatment of competing bidders or other suspicious conduct, *Paramount* has displaced the deference that otherwise should be accorded to a board's decisions in this context.[374]

As former-practitioner Veasey and Professor Dooley observed in their scholarly analysis of the business judgment rule, the power to interfere is tantamount to the power to decide.[375] The business judgment rule thus protects shareholders from each other by minimizing shareholder interference with the board's exercise of its managerial authority.[376] In this regard, it is worth noting that the shareholder who seeks to enlist the court's aid in interfering with the board's auction decisions often will be one of the competing bidders whose interests may not necessarily be aligned with those of shareholders generally.

In all events, it may reasonably be assumed that shareholders would benefit if courts applied the business judgment rule (assuming the elements of care, loyalty, and good faith are present) and accorded deference to the decisions of the board in a change-of-control setting. This approach would maximize the board's negotiating authority and provide greater certainty to the directors' decisions.[377] Not only

Judge Sand's memorable description of the poison pill's utility as a "shield to fend off coercive offers, and . . . a gavel to run an auction" implicitly recognizes that shareholders can benefit from upholding such centralized power in the hands of the board in the context of an auction for corporate control. CRTF Corp. v. Federated Dep't Stores, Inc., 683 F. Supp. 422, 439 (S.D.N.Y. 1988); *see also* Moran v. Household Int'l Inc., 490 A.2d 1059, 1083 (Del. Ch.) ("Household's claim that the Rights Plan provides it with much-needed flexibility in dealing with potential acquirors is clearly supported by the evidence."), *aff'd*, 500 A.2d 1346 (Del. 1985).

374. Unwilling to review the reasonableness of the directors' auction decisions in *RJR Nabisco*, Chancellor Allen observed: "To recognize in courts a residual power to review the substance of business decisions for 'fairness' or 'reasonableness' or 'rationality' where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors." *In re* RJR Nabisco, C.A. No. 10389, 1989 Del. Ch. LEXIS 9, at *41 (Del. Ch. Jan. 31, revised Feb. 14, 1989). This traditional business judgment rule analysis was later criticized in *Macmillan*. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287-88 (Del. 1989).

375. Dooley & Veasey, *supra* note 32, at 522 ("If stockholders are given too easy access to courts, the effect is to transfer decision-making power from the board to the stockholders or, more realistically, to one or a few stockholders whose interests may not coincide with those of the larger body of stockholders.").

376. *Id.*

377. Upon a showing of disparate treatment of competing bidders, a court would apply enhanced scrutiny because the suspicion aroused by such unequal treatment justifies elevating the value of responsibility at the expense of the value of authority. *Macmillan*, 559 A.2d at 1288; *see generally* Dooley, *supra* note 14, at 463-64, 467-71 (explaining that responsibility and authority are "antithetical" and that "more of one means less of the other").

would the board's negotiating hand be strengthened, but shareholders of a selling corporation would be less likely to endure the delays and risks of an unduly protracted bidding process.[378]

At its core, *Paramount*'s implicit "ownership" analysis—with its imposition of enhanced scrutiny for all takeover transactions—runs afoul of the Delaware General Corporation Law's allocation of managerial authority to the board as centralized decisionmaker. Section 141(a) provides that the "business and affairs" of every Delaware corporation "shall be managed by or under the direction of a board of directors."[379] In upholding antitakeover measures in *Unocal* and *Moran*, the Delaware Supreme Court gave special emphasis to the "and affairs" language of section 141(a), and thus implied that a board is vested with as much managerial authority in the context of "ownership" decisions as in the context of "enterprise" decisions.[380] Unfortunately, *Paramount*'s mandate of a reasonableness review for every takeover will enable shareholders to interfere with the board's managerial authority in cases in which the justifications for deference remain compelling.

iii. Summary

It is one thing to apply enhanced scrutiny to an "ownership" claim when the evidence provides good reason to question the direc-

378. As one observer of the recent battle for control of Grumman Corp. commented, it was important for a defense industry company like Grumman to avoid "the Paramount experience," a shorthand description for the "nasty and expensive battle that Viacom Inc. won over QVC Network Inc. to acquire Paramount . . . ." Roy J. Harris, Jr., *Northrop Sharply Objects, Claiming 'Unlevel' Field With Martin Marietta*, WALL ST. J., Mar. 29, 1994, at A3.

379. DEL. CODE ANN. tit. 8, § 141(a) (1991).

380. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 953 & n.6 (Del. 1985); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1353 & n.11 (Del. 1985); *see also* Paramount Communications v. Time. Inc., C.A. No. 10866 (Del. Ch. July 17, 1989), *reprinted in* 15 DEL. J. CORP. L. 700, 749-50 (1990) ("The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm."), *aff'd*, 571 A.2d 1140 (Del. 1990); *In re* RJR Nabisco, Inc. Shareholders Litig., C.A. No. 10389, 1989 Del. Ch. LEXIS 9, at *66 (Del. Ch. Jan. 31, revised Feb. 14, 1989) ("[T]he board of directors continues, in the auction setting as in others, to bear the burden imposed and exercise the power conferred by Section 141(a)."); BALOTTI & FINKELSTEIN, *supra* note 68, § 4.1, at 4-5 & n.3 (Delaware decisions "read the words 'and affairs' in Section 141(a) as giving a board of directors additional power to act in areas which are beyond the scope of the directors' duties in guiding the corporation's everyday business.") (footnote omitted); FOLK ET AL., *supra* note 62, § 141.2.4.1 at § 141:44 (discussing *Unocal*'s examination of inherent powers conferred on directors by "business and affairs" language of section 141(a)).

tors' motivations. It is quite another to review the substance of a board's decision simply because an important "ownership" issue is presented. *Paramount*'s transaction-significance rationale will allow shareholders to interfere with the board's "inherent powers"[381] to manage the corporation's "affairs" by instituting a layer of judicial review—not contemplated by section 141(a)—of the reasonableness of all board decisions in all takeover transactions. As the Delaware Supreme Court pointedly remarked in another context, there is a need for stability and certainty in the corporation law that should not be compromised by unnecessary judicial tinkering with the statute.[382] This was a lesson the *Paramount* court would have done well to remember.

D. Proposed Standard of Judicial Review for Change-of-Control Transactions

As discussed above,[383] the *Macmillan* court imported the "omnipresent specter" rationale from *Unocal*'s antitakeover setting to the takeover realm.[384] To the extent *Macmillan* could be interpreted as calling for enhanced scrutiny in all takeovers—including those in which competing bidders received equal treatment—this importation was illogical.[385] It is therefore understandable that the Delaware Supreme Court would use the *Paramount* decision as a vehicle to re-

381. *Moran*, 500 A.2d at 1353.

382. Stroud v. Grace, 606 A.2d 75, 87 (Del. 1992). As the court observed: "It is important that there be certainty in the corporation law. We emphasize that the Court of Chancery must act with caution and restraint when ignoring the clear language of the General Corporation Law in favor of other legal or equitable principles." *Id.* (footnote omitted) (citing Staar Surgical Co. v. Waggoner, 588 A.2d 1130, 1137 n.2 (Del. 1991); Alabama By-Products Corp. v. Neal, 588 A.2d 255, 258 n.1 (Del. 1991)).

383. *See supra* notes 201-205 and accompanying text.

384. Mills Acquisition Corp. v. Macmillan, Inc., 559 A.2d 1261, 1287 ("[W]here issues of corporate control are at stake, there exists 'the omnipresent specter that a board may be acting primarily in its own interests.'") (quoting *Unocal*, 493 A.2d at 954). Simply because a board approves a change-of-control transaction is no reason to suspect or question the motivations of the directors. To be sure, the possibility exists in this context that an inappropriately motivated board will steer a transaction to a favored bidder to the detriment of the company's shareholders. *See* Mirvis, *supra* note 200, at 63 (arguing that the "omnipresent specter" of potential director self-interest exists in all change-of-control transactions: "Whether or not to sell, and to whom (and under what conditions) to sell, are questions that are more alike than they are different"). Such inappropriate motivations, if they exist, will manifest themselves in suspicion-triggering conduct, which *Macmillan*'s disparate treatment/enhanced scrutiny test is sufficient to address. Absent such suspicion-triggering conduct, however, there is no reason to question or suspect the directors' motivations at the threshold, particularly when they approve a takeover that jeopardizes their own positions of control.

385. *See supra* notes 196-204 and accompanying text.

work the rationale for enhanced scrutiny in cases where directors approve and facilitate a takeover. Nevertheless, the *Paramount* court's reliance on the "significance" of change-of-control transactions as a justification for enhanced scrutiny in every takeover sweeps much too broadly.[386] Delaware's established model of governance requires deference to the directors' decisions, absent evidence of a destabilizing influence or some other reason to question the directors' motivations.[387] The value of accountability is elevated over that of deference only when there is a demonstrated reason not to trust the directors to act independently, advisedly, and in good faith.[388]

Consistent with Delaware's established model of corporate governance, the Delaware Supreme Court should modify *Paramount*'s overly broad rationale and return its threshold focus in takeover cases to the composition and activities of the selling corporation's board of directors.[389] Absent suspicion-triggering board conduct (like unequal treatment of competing bidders) or some other reason to question the board's loyalty, care, or good faith, the court should not apply enhanced scrutiny to a board's auction decisions. In such circumstances, there is every good reason, as a matter of law and policy, to uphold the authority of the board and apply the traditional business judgment rule.

As a matter of law, the Delaware General Corporation Law vests the shareholders' duly elected board with the power to manage the corporation's "business and affairs."[390] To afford shareholders access to the courts for a judicial assessment of the merits of a board's deci-

386. Paramount Communications v. QVC Network, 637 A.2d 34, 42, 43, 45, 48 (Del. 1994).

387. *See supra* Parts I.B and II.A.

388. *See supra* Parts I.B and II.A.

389. *See Macmillan*, 559 A.2d at 1279 ("[A] court . . . should decline to evaluate the wisdom and merits of a business decision unless sufficient facts are alleged with particularity, or the record otherwise demonstrates, that the decision was not the product of an informed, disinterested, and independent board.") (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)); *see also supra* Parts I.B, II.A, and III.A.

The proposed standard of judicial review suggested in this section pertains to board action taken in the context of a sale or change-of-control transaction. Such conduct may include the board's use of defensive measures to facilitate an orderly and effective auction or negotiation for a sale of control. *E.g.*, CRTF Corp. v. Federated Dep't Stores, Inc., 683 F. Supp. 422, 439 (S.D.N.Y. 1988). The recommendations set forth herein are not addressed to board action that is designed to thwart a potential takeover. *Unocal* plainly controls in such circumstances, and this Article does not propose to vary the enhanced scrutiny test in the antitakeover setting. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985). *But see supra* note 350.

390. DEL. CODE ANN. tit. 8, § 141(a) (1991).

sions in every takeover would effectively supplant this statutory allocation of authority.[391] As a matter of policy, shareholders likely will benefit by upholding and clarifying the board's authority to pursue the best available transaction, especially without the uncertainty created by the prospect of an after-the-fact ruling by the court on whether the board's decision falls within a judicially-defined range of reasonableness.[392]

Heightened scrutiny in change-of-control transactions thus should be limited to cases in which the directors have engaged in suspicion-triggering conduct, such as the disparate treatment of competing bidders or the adoption of defensive measures.[393] When directors have treated competing bidders evenhandedly,[394] and have not otherwise engaged in some form of suspicion-triggering conduct, the courts should apply the traditional business judgment rule. On the other hand, when such suspicion-triggering conduct has been shown, the court should apply the enhanced scrutiny test developed in *Macmillan* for such specific instances of disparate treatment.[395]

391. *See supra* notes 38-43 and accompanying text.

392. Paramount Communications v. QVC Network, 637 A.2d 34, 45 (Del. 1994).

393. Professor Dooley previously has examined *Revlon* and *Interco* from a perspective of suspicion of directors' motives arising from specific actions by directors in those cases:

> *Revlon* and *Interco* can be seen as cases where the specific action approved by the board strongly suggests self-interest. Why else would a faithful agent refuse to permit a competing proposal to be put forward if not for fear that his own proposal is, in fact, not competitive? And why would the honest auctioneer ever seek other than the highest bid if not to seek side payments or otherwise indulge personal preferences?

Dooley, *supra* note 14, at 521. If the evidence surpasses suspicion and shows a breach of any one of the board's duties of care, loyalty, or good faith, then the directors should be required to satisfy the test of entire fairness. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993); *see also supra* Part I.B.

394. The disparity of treatment among competing bidders that is sufficient to trigger enhanced scrutiny should be material to the competition. Thus, the mere signing of a merger agreement that includes a "fiduciary out" not encumbered by significant disincentives for a potential competing bidder to emerge should not be deemed disparate treatment within the meaning of this test. To be sure, the Chancellor appeared to find disparate treatment under similar circumstances in Roberts v. General Instrument Corp., C.A. No. 11639, 1990 Del. Ch. LEXIS 138, at *24-28 (Del. Ch. Aug. 13, 1990), *reprinted in* 16 DEL. J. CORP. L. 1540 (1991). Nevertheless, this ruling may be explained as an effort to avoid basing the decision on the uncertain scope of *Macmillan*—namely, whether enhanced scrutiny applies "only" when disparate treatment is shown or in all change-of-control transactions. *See id.* at *24-26; Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287-88 (Del. 1989).

395. *See Macmillan*, 559 A.2d at 1288; *see also supra* note 205. The board's use of defensive measures in an auction or negotiation for sale or control—such as the continued deployment of a poison pill during the pendency of an auction—likewise could be subjected to enhanced scrutiny under *Unocal*. *See* Paramount Communications v. Time, Inc.,

Moreover, if the directors satisfy their enhanced "*Macmillan* duty" by showing the reasonableness of such disparate treatment (and demonstrating that it legitimately furthered shareholder interests),[396] there is no reason to apply enhanced scrutiny to all other aspects of the change-of-control transaction. By satisfying the *Macmillan* test for reasonableness, the directors would have dispelled the threshold suspicions that such disparate treatment arouses. Having earned the court's trust, the directors should be accorded deference in all other aspects of their decisions (absent some other demonstrated reason to question the directors' bona fides).[397]

This proposed model of judicial review would better accommodate the competing goals of protecting shareholders' interests in takeovers and preserving the board's managerial authority under section 141(a). As discussed above,[398] upholding the board's authority in the takeover context would effectively protect the shareholders' interests by lending stability to the auction process and strengthening the board's negotiating position. At the same time, the proposed approach would permit heightened judicial scrutiny, in accordance with Delaware's established model of governance, when the evidence shows reasonable grounds to question the directors' motivations.

Alternatively, to the extent the court perceives a compelling need for a greater judicial role in takeover transactions—because of the important "ownership" issue presented in this context—the court could apply a modified test of enhanced scrutiny. Under this modified test, essentially confined to the first prong of *Paramount*'s two-part en-

571 A.2d 1140, 1151 n.14 (Del. 1990) ("[A] *Unocal* analysis may be appropriate when a corporation is in a *Revlon* situation . . . .") Such scrutiny should be confined to the specific defensive measure at issue—not extended to every aspect of the board's conduct in the auction.

396. *See Macmillan*, 559 A.2d at 1288 (holding that a board's unequal treatment of competing bidders "must be reasonable in relation to the advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests"); *see also In re* J.P. Stevens & Co. Shareholders Litig., 542 A.2d 770, 782 (Del. Ch. 1988) (upholding a selling corporation's agreement to pay a topping fee and break-up fee to one of three competing bidders and noting that "[i]t is the shareholders to whom the board owes a duty of fairness, not to persons seeking to acquire the Company"); *In re* Fort Howard Corp. Shareholders Litig., C.A. No. 9991, 1988 Del Ch. LEXIS 110, at *41 (Del. Ch. Aug. 8, 1988) ("[A] board . . . may never appropriately favor one buyer over another for a selfish or inappropriate reason, such as occurred in *Revlon*, but it may favor one over another if in good faith and advisedly it believes shareholder interests would be thereby advanced.").

397. *But see* Gilbert v. El Paso Co., 575 A.2d 1131, 1145 (Del. 1990) (applying *Unocal*'s enhanced scrutiny to directors' "overall response" to hostile tender offer because "all of the directors' actions here are so inextricably related").

398. *See supra* Part IV.C.(2)(c)(ii).

hanced scrutiny test,[399] the directors in every change-of-control transaction would be charged with the burden of demonstrating that they were adequately informed and otherwise free of any material interest or other destabilizing influence.[400] The court would not undertake a substantive review of the reasonableness of the board's auction decisions, however, unless (i) the director's decision-making process was found wanting or (ii) the directors had treated competing bidders on unequal terms or engaged in some other form of suspicion-triggering conduct. Otherwise, the courts will inappropriately displace the board's managerial authority and act as "super-directors."[401]

Of the two standards of judicial review for takeovers proposed here, the former, with its prerequisite of suspicion-triggering conduct for any form of enhanced scrutiny, is preferable. This standard, which builds soundly upon Delaware's established model of corporate governance, would appropriately uphold the statutory authority of the board. Moreover, it would carefully limit those instances in which the value of deference would be diminished, and that of responsibility elevated, to cases in which the evidence justifies suspicion of the board's motivation or ability to function properly as the centralized decisionmaker. The unquestioned significance of a change-of-control transaction, standing alone, does not supply this justification.

V. Conclusion

Under the business judgment rule, courts typically defer to a board's decisions, absent evidence of a breach of the directors' duties of care, loyalty, or good faith. The courts' reluctance to assess the wisdom of directors' decisions encourages innovation and en-

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399. Paramount Communications v. QVC Network, 637 A.2d 34, 45 (Del. 1994). The *Paramount* court articulated the following two-part enhanced scrutiny test for all change-of-control transactions:

> The key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decision-making process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.

Id.

400. Being adequately informed in a takeover transaction naturally requires greater information than is required for less significant decisions. *See, e.g., Fort Howard*, 1988 Del. Ch. LEXIS 110, at *5 ("When the decision is to sell the company, or to engage in a recapitalization that will change control of the firm, the gravity of the transaction places a special burden upon the directors to make sure that they have a basis for an informed view.").

401. *In re* RJR Nabisco, Inc. Shareholders Litig., C.A. No. 10389, 1989 Del. Ch. LEXIS 9, at *41 (Del. Ch. Jan. 31, revised Feb. 14, 1989).

trepreneurial risk-taking by removing the chilling threat that courts will unfairly second-guess a board's decisions based on their eventual outcome. This deference also upholds the corporation law's allocation of managerial authority to the board as centralized decisionmaker. When a shareholder plaintiff provides evidence that the directors have breached their duties of care or loyalty, or otherwise have failed to act in good faith, the threshold presumption of propriety attaching to the directors' decisionmaking is rebutted. The working model of deference is displaced, and the value of accountability is emphasized. Consequently, the directors are required in such circumstances to prove the entire fairness of the challenged transaction to the shareholders.

In *Unocal*, the Delaware Supreme Court introduced an intermediate or "enhanced" standard of judicial review for cases in which directors attempt to block a takeover and thereby preserve their positions of control.[402] In the year after *Unocal* was decided, the Delaware Supreme Court issued its landmark decision in *Revlon* and announced that directors overseeing the sale of a corporation are "charged with getting the best price for the stockholders . . . ."[403] It remained for later cases to clarify the standard of review that would apply to claims arising in this takeover (as opposed to the *Unocal* antitakeover) setting.

Three years after its opinion in *Revlon* was announced, the Delaware Supreme Court declared in *Macmillan* that the "omnipresent specter" of potential self-interest which *Unocal* addresses also is present in takeover transactions "where issues of corporate control are at stake."[404] *Macmillan* was unclear, however, regarding whether enhanced judicial scrutiny would apply in all change-of-control transactions or only in those takeovers in which the directors treat competing bidders unequally and therefore arouse suspicion about the directors' motivations. To the extent the *Macmillan* court intended enhanced scrutiny to apply in all takeover transactions, the decision arguably rested on an illogical premise. Specifically, in announcing enhanced scrutiny for "*Revlon*" cases, the *Macmillan* court imported the "omnipresent specter" rationale of *Unocal*—which addresses the potential

402. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (referring to directors' "inherent conflict" in this setting); *see also* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986) (describing the "potential for conflict" which *Unocal* addresses).

403. *Revlon*, 506 A.2d at 182.

404. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287 (Del. 1989).

conflict that directors face when resisting a takeover—to a board's decision to approve a change of control.

Although the court in *Paramount* understandably sought to modify the reasoning supporting enhanced scrutiny in takeovers, the reformulated rationale which the *Paramount* court developed is overbroad. The law now requires enhanced scrutiny in every change-of-control transaction solely because of the significance of such transactions to the corporation's owners. The admitted significance of a change of control provides legitimate grounds for triggering a board's duty under *Revlon* to seek the best available transaction. It does not follow, however, that the decisions of a board in this context are so inherently open to question or suspicion that the traditional business judgment rule should not apply.

Paramount departs from Delaware's established model of corporate governance—including the model that emerged in the post-*Unocal* era—by shifting the court's threshold focus away from the integrity and effectiveness of the board's decision-making process to the importance of the transaction to be acted upon. The Delaware Supreme Court therefore should modify its overly-broad rationale for enhanced scrutiny in takeover transactions. Heightened scrutiny should be applied in this context only when the threshold evidence shows that the board has engaged in suspicion-triggering conduct, like treating competing bidders unequally. Only upon such a showing should the directors be required to demonstrate (i) the adequacy of their decision-making process and (ii) the reasonableness of their conduct. Absent evidence of such suspicion-triggering conduct, the decisions of a predominantly disinterested board in the conduct of an auction should be accorded the deference of the business judgment rule from the outset.

Alternatively, as a means of establishing a greater judicial role in the context of takeovers, the courts could apply a modified test of enhanced scrutiny. Under this modified test, directors would have the threshold burden in all takeover cases to demonstrate the adequacy of their decision-making *process*. The courts would not engage in a substantive review of the reasonableness of the directors' decisions unless (i) the decision-making process was found wanting or (ii) the directors had treated competing bidders unequally or engaged in some other form of suspicion-triggering conduct.

Under either proposed standard of review, the court's role would be more limited than that which *Paramount* envisions. Enhanced judicial scrutiny of takeovers would appropriately be limited to cases in which there is a demonstrated reason to question the proper functioning of the board. Only when the evidence provides grounds for questioning a board's motives or its capacity to function properly should the courts decline to accord deference to directors' decisions in the takeover context. The significance of a change-of-control transaction, without more, does not supply the justification for such substantive judicial review.