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The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies

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THE AVAILABILITY OF TAKEOVER DEFENSES AND DEAL PROTECTION DEVICES FOR ANGLO-AMERICAN TARGET COMPANIES

Albert O. “Chip” Saulsbury, IV

ABSTRACT

On July 21, 2011 the U.K.’s Panel on Takeovers and Mergers (the “Panel”) released amendments to the City Code on Takeovers and Mergers (the “Takeover Code”). These amendments, which take effect on September 19, 2011, will have a significant impact on the manner in which companies in the U.K. engage in mergers and acquisitions (“M&A”) and will amplify the differences between British and American deal activity. Because of these amendments to the Takeover Code within the last month, the following Article, The Availability of Takeover Defenses and Deal Protection Devices for Anglo-American Target Companies, is especially timely and will provide the first post-revision analysis comparing the legal regimes governing Anglo-American M&A.

The board of directors for U.S. target companies can use takeover defenses to divert hostile offers into a negotiated acquisition process, which generates more negotiating power and ultimately allows the board to maximize shareholder value in M&A transactions. During negotiations, directors also have the ability to incorporate provisions in the merger agreement known as deal protection devices, which ultimately lead to an increased price and higher premiums for shareholders. The substantive rules developed through the Delaware common law and the Delaware General Corporation Law place the ultimate power and authority in the hands of the board of directors during the sale of the company. Directors of target companies in the U.K. are not vested with the same ability to divert offers into a negotiation process. Instead, takeover defenses are strictly prohibited in the U.K., and the Panel’s recent revisions to the Takeover Code prohibit the use of deal protection devices. By eliminating takeover defenses and deal protection devices, the Takeover Code significantly reduces the board’s negotiating power.

This Article argues that the availability of takeover defenses and deal protection devices under Delaware corporate law gives directors of U.S. target companies more negotiating power and allows them to generate higher premiums for shareholders in M&A transactions compared to their colleagues in the U.K. The Delaware courts’ use of a malleable reasonableness standard allows directors to adapt to the unique circumstances surrounding each deal, while holding directors accountable under a fiduciary duty analysis. This is in stark contrast to the bright line rules of the U.K.’s recently amended Takeover Code, which strip the board of any ability to use takeover defenses and deal protection devices. Instead, the authority to decide on the merits of a transaction in the U.K. rests solely with the shareholders of the company, which prohibits directors from negotiating higher priced deals.

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INTRODUCTION

Dams are often built to divert river water to generate hydroelectric power, irrigate farmland, or for other purposes that benefit the community. After being diverted, the water is released and then flows downriver. In a similar fashion, the board of directors for U.S. target companies can use takeover defenses to divert hostile offers into a negotiated acquisition process, which generates more negotiating power and ultimately maximizes shareholder value. While in the negotiating process, directors also have the ability to negotiate provisions known as deal protection devices, which, as

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1 See infra, Part III.C.
empirical studies show, lead to an increased price and higher premiums for shareholders in the majority of deals.2

Directors of target companies in the U.K. do not have the same ability to divert offers into a negotiation process. Instead, takeover defenses are strictly prohibited in the U.K.,3 and the British regulatory authorities recently banned directors’ use of deal protection devices in July 2011.4 This Article argues that the ability to use deal protection devices and takeover defenses gives directors of U.S. target companies more negotiating power and control over the sale of the company, which ultimately leads to increased premiums for shareholders. This argument finds support from practitioners, legal and financial scholars, and several empirical studies. Part I of this Article provides a background of the different regulatory approaches taken in the U.S. and U.K. Part II briefly discusses the similar director approval requirements and business judgment rule standard in the two jurisdictions. Finally, Parts III and IV discuss the availability of takeover defenses and deal protection devices respectively and conclude that the ability of U.S. directors to use these measures ultimately benefits companies and their shareholders.

I. DIFFERENT APPROACHES: REGULATION OF MERGERS AND ACQUISITIONS

The U.S. and the U.K. take very different approaches to regulating mergers and acquisitions (“M&A”). The U.K. adopted a codified system of rules, which is primarily enforced through a regulatory agency. By contrast, the rules regulating deal activity in the U.S. have largely been developed through common law derivative suit litigation within the Delaware courts.

A. United States: Delaware Common Law

For a number of reasons, most of the nation’s largest corporations incorporate in Delaware, including “50% of all publicly-traded companies in the United States” and “63% of the Fortune 500.”5 Therefore, Delaware law governs the fiduciary duties of directors in the majority of M&A transactions involving of public companies in the U.S., making it “by far the most important source of regulation.”6 The Securities and Exchange

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2 See infra, Part IV.C.
3 See infra, Part III.B.
4 See infra, Part IV.B.
Commission ("SEC") does regulate tender offers and merger activity, but its regulations focus on disclosure, not necessarily the decisions made by the board of directors. Therefore, the primary source of regulation for target directors’ decision-making in M&A comes from decisions of the Delaware courts in derivative suit litigation and suits seeking preliminary injunctions of deals.

1. Delaware’s Regulatory Scheme

Under section 141(a) of the Delaware General Corporation Law ("DGCL"), the business and affairs of the corporation are managed under the direction of the board of directors.\(^7\) In conjunction with the grant of this power, Delaware law also imposes fiduciary duties on the directors to the corporation and its shareholders.\(^8\) Therefore, as discussed in great detail below, in the context of mergers or acquisitions, the directors of target companies owe a fiduciary duty of care to the shareholders during the sale of the company.\(^9\) Under Delaware law, shareholders can challenge the directors’ decisions by filing a derivative suit,\(^10\) which allows "shareholders to sue in the corporation’s name where those in control of the company refused to assert a claim belonging to it."\(^11\) In these actions, shareholders bring a claim on behalf of the company asserting that mismanagement or negligence by directors caused economic injury to the company.\(^12\) These suits are filed in the Delaware Court of Chancery ("Chancery Court") and ultimate appellate authority lies with the Supreme Court of Delaware.

2. The Delaware Court of Chancery

The Chancery Court is considered the nation’s most sophisticated and efficient corporate law arbiter. This is true both because of the frequency with which the members of the Chancery Court review corporate law issues and their experience and education prior to reaching the bench.\(^13\)

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\(^7\) 1735 (2007). Delaware corporate law is very influential and also affects companies incorporated in other states because courts apply decisions of the Delaware courts to their own corporate law on a regular basis. For recent representative examples, see Berry ex rel. Dillard’s, Inc. v. Dillard, 2011 WL 1144697 (Ark. Ct. App. 2011) (applying the demand futility rules from Aronson v. Lewis, 473 A.2d 805 (Del. 1984)); Smith v. Raymond, 2010 WL 5557507 (N.C. Superior Ct. 2010).

\(^8\) 7 DEL. CODE ANN. tit. 8, § 141(a) (Supp. 2010).

\(^9\) See infra Part II.B. (discussing directors’ duty of care in M&A).

\(^10\) Aronson, 473 A.2d at 811. See also DEL. CHANC. CT. R. 23.1 (West 2011).

\(^11\) Id.

\(^12\) Id.

\(^13\) See Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law
The members of the Chancery Court continue to keep in touch with trends in the market, “compar[ing] notes, often over lunch, about emerging corporate law issues, which enables them to begin mulling over new developments long before a particular dispute arises.”

Even though most state trial courts do not publish opinions, because of the Chancery’s influence on corporate law, the majority of its opinions are published and available for review by directors and attorneys representing corporations. The opinions are often extremely long and detailed. For example, in the recent case, *Air Products and Chemicals, Inc. v. Airgas, Inc.* , the Chancery Court issued a 158 page opinion. Given the complexity of the deals involved and the Chancery’s thorough analysis of all issues, this length is necessary in many circumstances. The court “do[es] this, in part, because of the possibility that the Opinion[s] may serve as guidance for future officers and directors—[not only of] the company involved in litigation, but of other Delaware corporations.” The Chancery Court will often critique the performance of directors, even those who have not violated their fiduciary duties, in order to offer guidance and establish best practices for other directors in future deals. The court’s instructive approach is extremely helpful for providing directors with guidance when faced with difficult issues surrounding future deal activity. As discussed below, this detailed analysis is unique to the American system, and directors of British targets do not receive similar guidance.

**B. United Kingdom: the Takeover Panel and the City Code on Takeovers and Mergers**

In stark contrast to Delaware, the powers and duties of directors for British target companies engaged in M&A are not defined through common

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14 Armour & Skeel, supra note 6, at 1749.
16 In re The Walt Disney Derivative Litig., 907 A.2d 693, 698 (Del. Ch. 2005).
17 See Armour & Skeel, supra note 6, at 1749.
law derivative actions. Much of the reason for this is the differences in the legal profession in the two countries and the greater financial incentive for attorneys in the U.S. to bring derivative actions compared to their colleagues in the U.K.\textsuperscript{18} Also, institutional investors in the U.K. have not taken an active role in bringing derivative actions.\textsuperscript{19} These factors have resulted in a significantly lower amount of deals being challenged through derivative suits in the U.K. compared to the U.S.

From 1990 to 2005, there were 312 hostile takeover bids of publicly traded targets announced in the United States.\textsuperscript{20} Of these bids, 106, or 33.9\%, were litigated through derivative suits.\textsuperscript{21} These numbers were significantly lower in the U.K., where two of the 187 hostile takeover bids were litigated, only 0.1\%.\textsuperscript{22} The differences in the legal profession in the U.K. is not the sole driving force behind the lower percentage of derivative suits filed challenging M&A activity. The statutory authority in place and the methodology of the regulatory body is also responsible for this trend.

1. Emergence of the Panel on Takeovers and Mergers

Instead of relying on the common law as developed by the court system, British professionals involved in M&A formed a system of self-regulation, and institutional investors have played a significant role in shaping this system.\textsuperscript{23} Historically, British institutional investors have

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\textsuperscript{18} In the U.S., derivative suit litigation is largely driven by the incentive of the plaintiffs’ bar to obtain contingency fees. See William B. Rubenstein, A Transactional Model of Adjudication, 89 GEO. L.J. 371, 397-98 (2001). See also Geoffrey Miller, Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England, 1998 COLUM. BUS. L. REV. 51, 67–68 (1998). Pursuant to Rule 2.4 of the Solicitors’ Code of Conduct, attorneys in the U.K. may not enter into contingency fee arrangements. SOLICITORS’ CODE OF CONDUCT, 2007, R.2.4 (Eng.) (“You must not enter into an arrangement to receive a contingency fee for work done in prosecuting or defending any contentious proceedings before a court of England.”) Therefore, the financial incentive to obtain contingency fees that drives derivative actions for directors’ breach of fiduciary duty in the Delaware courts is not present in the U.K.

\textsuperscript{19} See Miller, supra note 18, at 62–63 (stating that institutional investors “do not want to incur the costs and inconvenience of derivative litigation, which ties up senior fund managers’ time, results in costs that cannot easily be passed on to fund clients, and invites free riding by other shareholders who do not contribute to the litigation.”

\textsuperscript{20} Armour & Skeel, supra note 6, at 1748, Table 2.

\textsuperscript{21} \textit{Id.}

\textsuperscript{22} \textit{Id.}

\textsuperscript{23} Armour & Skeel, supra note 6, at 1730 (“In the United Kingdom, the self-regulatory system was orchestrated principally by the community of investment bankers and institutional investors, all of whom regularly rub shoulders in the “City,” the one-square-mile district where London's business community is located.”).
taken a passive approach regarding governance issues for individual companies, and instead choose to move on and sell their shares. However, they have played an active role in dictating market-wide trends by intervening significantly in the regulatory process, including the formation of the Panel on Takeover and Mergers (the “Takeover Panel”).

In its current form, the Takeover Panel is composed of 35 members from major financial and business institutions including the Stock Exchange, the Bank of England, other major banks, and institutional investors. The Panel’s composition, according to its website, “giv[es] it an unrivalled expertise in takeovers and securities markets.” Certain constituencies have the ability to directly appoint members to the Panel, including groups that represent the British financial sector and even groups that directly represent classes of institutional investors. Once appointed to the Takeover Panel, its members are charged with enforcing a codified system of rules known as the City Code on Takeover and Mergers (the “Takeover Code”).

The Takeover Code “is concerned with regulating takeover bids and merger transactions.” It was drafted “principally to ensure that shareholders are treated fairly and are not denied an opportunity to decide on the merits of a takeover.” The main concern is not the financial or commercial advantages or disadvantages of a deal; instead, the Code leaves these decisions to the company’s shareholders. Institutional investors played a major role in shaping this policy:

Institutional investors were involved at every stage of the drafting of the Code, right from its beginnings as the Notes.

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24 Id. at 1770.
25 Id. at 1771.
26 See id. at 1744.
28 These groups include: “The Association for Financial Markets in Europe (with separate representation also for its Corporate Finance Committee and Securities Trading Committee) . . . The Association of Private Client Investment Managers and Stockbrokers . . . The British Bankers’ Association . . . The Institute of Chartered Accountants in England and Wales . . . The Investment Management Association.” Id.
29 These groups include: “The Association of British Insurers; The Association of Investment Companies . . . The National Association of Pension Funds.” Id.
31 TAKEOVER CODE, Intro. § 3(b).
32 TAKEOVER CODE, Intro. § 3(b) (emphasis added).
33 TAKEOVER CODE, Intro. § 2(a).
Because institutional investors have a clear interest in rules that maximize expected gains to shareholders, it is not surprising that the emergence of a pro-shareholder approach to takeover regulation coincided with the emergence of institutional investors as a significant force in British share ownership.  

As discussed below, this general policy of vesting shareholders with decision-making authority drives much of the Code’s substantive rules.  

The Takeover Code is most concerned with the process that should take place during deals. It is intended to “provide[] an orderly framework within which takeover bids may be conducted.” The Code lists six “General Principles” that set forth its primary policies. These principles are “expressed in broad general terms and the Code does not define the precise extent of, or the limitations on, their application.” Instead, “they are applied in accordance with their spirit in order to achieve their underlying purpose.” Proponents argue that this system allows the Panel to “adjust its regulatory responses both to the particular parties before it, and to the changing dynamics of business.”

The Code also provides bright line rules that govern target directors’ activity during the sale of a company, including certain disclosure requirements, and also standards of conduct for directors during the deal process. However, “[c]ontravention of a rule-based requirement or a disclosure requirement does not give rise to any right of action for breach of statutory duty” by a director. This prevents shareholders from also bringing a derivative suit and exposing directors to possible multiple liability for the same activity. This is a stark contrast to how the deal activity of directors is regulated in the U.S., where derivative suits based on breach of fiduciary duty control the actions of directors. Instead, a different means of enforcement has been used in the U.K.

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34 Armour & Skeel supra note 6, at 1771.
35 See infra Parts III.B, IV.B.
36 TAKEOVER CODE, Intro. § 2(a).
37 TAKEOVER CODE, General Principles 1–6.
38 TAKEOVER CODE, Introduction, 2(b).
39 TAKEOVER CODE, Introduction, 2(b).
40 Armour & Skeel, supra note 6, at 1745.
41 See TAKEOVER CODE, R. 25.I. 30.1. 30.2.
42 See TAKEOVER CODE, R. 25.I. See also infra Part II.A.2.
43 See TAKEOVER CODE, R. 3.I. App. § 3(1). See also infra Parts II.B.2, III.B., IV.B.
44 COMPANIES ACT, 2006, c.46 § 956(1) (Eng).
2. Enforcement of the Takeover Code

When the Code was first drafted in 1968, the Takeover Panel did not have statutory authority under the Companies Act.\(^{45}\) Therefore, the Panel could not enforce the substantive provisions of the Code through fines, injunctions, or ordering the payment of compensatory damages.\(^{46}\) Instead, the Panel issued formal public censures of violators and “implored the investment banks that advised parties in takeover transactions to honor its rulings by holding the banks responsible for their clients’ violations.”\(^{47}\) This was done through a process called “cold shouldering,” where the banking community and investors would refuse to deal with companies that violated the Code.\(^{48}\) This threat forced directors of public companies to follow the Code’s provisions, because otherwise they could not obtain the services of investment bankers, which made it difficult for the company to raise capital in the future.\(^{49}\) As stated by former Takeover Panel Chairman Robert Alexander:

> It is sometimes said that the Panel lacks adequate power of sanction. In fact, the decisions of the Panel are in practice complied with. Almost all of those with whom the Panel deals are concerned to comply, and to be seen to comply with the Code. This reflects in very great part the grave damage to the reputation of individuals, advisers and companies which would result from a breach of the Code or a failure to accept our decisions.\(^{50}\)

From its original drafting and until 2004, the Panel enforced the Takeover Code in this fashion. However, in 2004, the European Parliament enacted what became known as the “Takeover Directive.”\(^{51}\) This EU directive “require[d] the Member States to designate competent authorities for the supervision of bids and to equip them ‘with all the powers necessary for the purpose of carrying out their duties, including that of ensuring that


\(^{46}\) Id. at 215.

\(^{47}\) Id.

\(^{48}\) Id. at 218–19.

\(^{49}\) Id.


the parties to a bid comply with the rules made.”52 The result of the U.K.’s implementation of the Takeover Directive came in Companies Act section 943, which statutorily adopted the rules of the Takeover Code currently in effect.53 Section 943 also gives the Takeover Panel the authority to enact future rules regulating: “(i) takeover bids, (ii) merger transactions, and (iii) transactions . . . that have or may have, directly or indirectly, an effect on the ownership or control of companies.”54 The statute also grants the Takeover Panel authority to “give rulings on the interpretation, application or effect of rules,” which “subject to any review or appeal . . . has binding effect.”55 The Takeover Panel may impose compensatory damages resulting from the violation of a rule,56 or obtain a court order enforcing a ruling to enjoin a deal.57 Although the investment community can continue to use the self-regulating methods of enforcement through “cold shouldering,” the Takeover Panel now has statutory authority to enact, interpret, and enforce its own rules pursuant to the Companies Act.

The Panel Executive conducts the day-to-day interpretation and enforcement of the Code.58 The Executive is not an individual, but rather a group staffed by employees “from law firms, accountancy firms, corporate brokers, investments banks and other organisations.”59 Proponents of the British system enthusiastically point out that the U.K.’s Takeover Panel and Executive are “[s]taffed by personnel on [temporary leave] from the professional community that it regulates,”60 and describe this staff as “experts.”61 Even after obtaining statutory authority through the Companies Act, the Panel is still seen as having a “self-regulatory structure” and that “the proximity between the regulators and the industry players means that the Panel has enhanced credibility.”62

The British system forces dealmakers to work closely with the Panel Executive. In fact, the Takeover Code imposes an affirmative duty

53 COMPANIES ACT, 2006, c.46 § 943(3) (Eng.).
54 COMPANIES ACT, 2006, c.46 § 943(2)(a) (Eng.).
55 COMPANIES ACT, 2006, c.46 § 945 (Eng.).
56 COMPANIES ACT, 2006, c.46 § 954 (1) (Eng.) (“Rules may confer power on the Panel to order a person to pay such compensation as it thinks just and reasonable if he is in breach of a rule the effect of which is to require the payment of money.”).
57 COMPANIES ACT, 2006, c.46 § 955(1) (Eng.).
58 TAKEOVER CODE, Intro. § 5.
60 Armour & Skeel, supra note 6, at 1729.
61 Johnston, supra note 52, at 422.
62 Rosensweig, supra note 45, at 233.
on management to seek advance guidance from the Executive by requiring that “[a]ny director who has a question concerning the propriety of any action as far as the Code is concerned should ensure that the Panel is consulted.”63 Therefore, target companies must communicate with the Executive, which provides “rulings on the interpretation, application or effect of the Code before, during and, where appropriate, after takeovers or other relevant transactions.”64 This gives the Panel “jurisdiction to control nearly all aspects of the tender offer [and merger] process.”65 Much of the communication with the Executive is very informal and most of the regulatory issues in deals are resolved with no more than a telephone call.66 However, if the parties disagree with the Executive, they may request a proceeding in front of the Panel’s Hearings Committee, which will issue its rulings in the form of a published “Panel Statement.”67 These rulings are subject to an internal appeals process68 and judicial review, but the courts are extremely deferential to the Panel’s interpretation of the Code.69 Therefore, the Takeover Panel has significant power and takes an extremely hands on approach to regulating M&A transactions.

C. Compatibility of Regulatory Regimes with Respective Substantive Rules

U.S. companies engaged in M&A also interact with several regulatory authorities throughout the process. For example, companies must communicate with the Federal Trade Commission and Department of Justice to receive antitrust approval before a deal is consummated.70 Companies also communicate with the SEC to confirm compliance with securities laws, and the Internal Revenue Service to ensure the desired tax treatment of the deal.71 Because U.S. companies already have to communicate with a number of regulatory agencies during the process of a deal, having to interact with an additional regulatory agency similar to the

63 TAKEOVER CODE, Appendix § 3(1). See also TAKEOVER CODE, Intro. § 5(b) (“When a person or its advisers are in any doubt whatsoever as to whether a proposed course of conduct is in accordance with the General Principles or the rules, or whenever a waiver or derogation from the application of the provisions of the Code is sought, that person or its advisers must consult the Executive in advance.”).
64 TAKEOVER CODE, Intro. § 5(a).
65 Rosensweig, supra note 45, at 233.
66 See Armour & Skeel, supra note 6, at 1747.
67 TAKEOVER CODE, Intro. §§ 5(b), 7(a), 7(c). “Proceedings before the Hearings Committee are informal. There are no rules of evidence.” TAKEOVER CODE, Intro. § 7(c).
68 TAKEOVER CODE, Intro. § 8.
69 Rosenzweig, supra note 45, at 222–23.
U.K.’s Takeover Panel would not be overly burdensome. In fact, some scholars advocate that Congress should create a body similar to the Takeover Panel in the U.S.\footnote{See Samuel C. Thompson, Jr., Change of Control Board: Federal Preemption of the Law Governing Target’s Directors, 70 Miss. L. J. 35 (2000).} However, with the substantive rules currently in place, there is no need for an entity such as the Takeover Panel in America’s regulatory scheme.

A large portion of the Takeover Panel’s role in regulating deal activity includes enforcing the disclosure requirements of the Code.\footnote{See infra Part II.B.2.} However, the SEC primarily performs this function in the U.S.\footnote{While enforcing disclosure requirements is primarily performed by the SEC, the Delaware courts have also recently played a role in enforcing disclosure requirements. See Lloyd L. Drury, III, Private Equity and the Heightened Duty of Disclosure, 6 N.Y.U. J. L. & Bus. 33 (2009).} Also, as discussed in depth below, the substantive rules in the U.S. give a large amount of autonomy to directors of target companies in deciding the adequacy of an offer to purchase the company.\footnote{See infra Parts III.A., IV.A.} These rules, as established in the Delaware courts, provide malleable standards that allow directors to consider a number of factors surrounding the deal and decide if an offer is in the best interest of the company and its shareholders.\footnote{See infra Parts III.B., IV.B.} This is a stark contrast to the U.K.’s Takeover Code, which sets forth bright line rules that prohibit directors from denying shareholders the opportunity to decide on the merits of a bid.\footnote{See infra Parts III.A., IV.A.} A regulatory agency, such as the U.K.’s Takeover Panel, has the ability to enforce these bright line rules, but it would be inappropriate to vest such an agency with the authority to enforce the substantive rules currently in place in the U.S.\footnote{See Stephen M. Bainbridge, Director Primacy in Corporate Takeovers: Preliminary Reflections, 55 STAN. L. REV., 791 at 814 (2002) (hereinafter Bainbridge, Director Primacy).} This would essentially give regulators the ability to determine the adequacy of offers, which undermines directors’ ability to make decisions that are in the best interests of the company and its shareholders. Therefore, because of the substantive rules in place, an entity similar to the U.K.’s Takeover Panel does not have a place in the American regulatory scheme.

Because the courts generally prefer standards to the bright line rules found in the U.K., the Delaware common law is more malleable than the Takeover Code.\footnote{See infra Part III.A.} According to Chancellor Strine, “large, publicly traded corporations rationally choose Delaware law because its preference for flexibility rather than rigidity allows corporate boards to structure corporate
transactions in a manner best tailored to the particular circumstances their corporations face.”

The opinions are styled in a manner that provides general principles, and much of the tests created allow courts to consider a number of appropriate factors based on the facts and circumstances surrounding a deal. However, the U.K.’s bright line rules do not allow the same flexibility. Therefore, the U.S. system possesses greater substantive flexibility than the U.K. In addition to their ability to adapt to the changing dynamics of deals, by vesting the board with the autonomy to control the sales process, the substantive rules in the U.S. ultimately add value to shareholders in the sale of the company.

II. SIMILAR REQUIREMENTS: DIRECTOR APPROVAL AND THE BUSINESS JUDGMENT RULE

Despite the different approaches that the U.S. and U.K. take in regulating M&A, the substantive requirements for director approval and advisability are almost identical. The general powers and duties of American and British directors also parallel one another. With respect to target companies engaged in M&A, the following section provides a brief background of these requirements.

A. Director Approval and Advisability Requirements

Both jurisdictions require directors of a target company to approve merger transactions. In the U.S., under section 251 of the DGCL, the shareholders of a target company in a merger transaction must approve the merger agreement by majority vote. Additionally, the board of directors must “adopt a resolution approving an agreement of merger or consolidation and declaring its advisability.” In their recommendation to shareholders, “Delaware law requires directors [to] disclose such information about the background of the transaction, the process followed by them to maximize value in the sale, and their reason for approving the transaction so as to be materially accurate and complete.”

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81 See discussion infra Part III.A.
82 Strine, Delaware’s Corporate-Law System, supra note 80, at 1263.
83 See infra Part III.A, IV.A.
84 DEL. CODE ANN. tit. 8, § 251(a), (c) (Supp. 2011).
85 DEL. CODE ANN. tit. 8, § 251(b) (Supp. 2011).
must also disclose the terms of the merger agreement in item 1.01 of SEC Form 8-K\(^87\) and in the proxy statement to shareholders.\(^88\) Despite the fact that DGCL section 251 gives directors approval and recommendation authority in the context of merger or consolidation transactions,\(^89\) “traditionally the board has been given no statutory role in responding to a public tender offer” under Delaware corporate law.\(^90\)

However, U.S. securities law does give directors some duties in the context of a hostile tender offer. Rule 14e-2 under the Securities Exchange Act of 1934 is “designed to prevent fraudulent, deceptive or manipulative acts or practices” in the context of takeover bids.\(^91\) Within ten days of receiving a tender offer, the target company must “publish, send or give to security holders a statement disclosing [whether the company recommends acceptance or rejection of the bidder’s tender offer].”\(^92\) Both the state law and federal securities law requirements governing directors of target companies in the U.S. are very similar to those found in the U.K.

Similar to DGCL section 251, section 905 of the U.K. Companies Act requires that a “draft of the proposed terms of the [merger] must be drawn up and adopted by the directors of the merging companies.”\(^93\) U.K. shareholders must also approve the deal “by a majority in number, representing 75% in value, of each class of members” in the target company.\(^94\) Rule 25.1 of the Takeover Code sets forth directors’ advisability requirements for both mergers and takeover bids and requires the directors of the target company to “send its opinion on the offer (including any alternative offers) to the [target] company’s shareholders.”\(^95\) Directors must send this document, called the “Offeree Board Circular” in the U.K., to shareholders, and must disclose “the substance of the advice given to it by the independent [financial] advisers appointed” by the board.\(^96\) This is essentially the same standard as in Delaware, which requires disclosure of the “reason for approving the transaction.”\(^97\) Also, similar to the requirements under U.S. Form 8-K, Rule 2.6 of the Takeover Code requires the target company to publish an announcement of the

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\(^{87}\) SECURITIES AND EXCHANGE COMMISSION, FORM 8-K, Item 1.01.

\(^{88}\) See SECURITIES AND EXCHANGE COMMISSION, FORM S-K, Item 4(a)(1).

\(^{89}\) DEL. CODE ANN. tit. 8, § 251(a), (c) (Supp. 2010).

\(^{90}\) Air Prods. & Chems., Inc. v. Airgas, Inc., 2011 WL 519735 at *27 (Del.Ch. 2011).

\(^{91}\) 17 C.F.R. § 240.14e-2(a) (2010).


\(^{93}\) COMPANIES ACT, 2006, c.46 § 905(1) (Eng.).

\(^{94}\) COMPANIES ACT, 2006, c.46 § 907(1) (Eng.).

\(^{95}\) TAKEOVER CODE, R.25.1(a).

\(^{96}\) TAKEOVER CODE, R.25.1(a), R.30.2.

merger, and Rule 30.1 requires directors to send a copy of the merger agreement to shareholders. As displayed above, the director approval and advisability requirements are nearly identical in the U.S. and the U.K.

B. General Duty of Care and the Business Judgment Rule

Similar to the director approval and advisability requirements, the general powers and duties of American and British directors under Delaware corporate law and the Takeover Code parallel one another.

1. United States: Smith v. Van Gorkom

In conjunction with DGCL section 141’s grant of power to manage the business and affairs of the corporation, Delaware corporate law imposes upon directors an array of fiduciary duties to corporation and its shareholders. In the context of M&A transactions, the directors of target companies owe a fiduciary duty of care to its shareholders in the process of selling the company. In fulfilling their fiduciary duties, Delaware law generally affords directors the protection of the business judgment rule, which the Delaware Supreme Court has defined in the following manner:

The business judgment rule is a “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” 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.”

Therefore, if a target board can find a rational business purpose behind its decision to either accept or reject an offer, Delaware courts are deferential and grant business judgment rule protection.

In the 1985 case, Smith v. Van Gorkom, the Delaware Supreme Court issued its bedrock decision concerning management’s process during the sale of a company, requiring that the board be must adequately informed in determining the merits of an offer. To receive business judgment rule

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98 TAKEOVER CODE R. 30.1.
99 DEL. CODE ANN. tit. 8, § 141(a) (Supp. 2010).
protection under Van Gorkom, the board should hire independent investment bankers to value the company and assess the adequacy of the offer.\textsuperscript{103} Under DGCL section 141(e), if these advisors are selected with reasonable care, then the directors may rely on their advice and reports.\textsuperscript{104} Van Gorkom also requires the board to have adequate information about the terms of the merger agreement prior to signing and have the opportunity to probe and ask questions regarding its substance and the accompanying valuation studies through regular board meetings during negotiations.\textsuperscript{105} Throughout the sales process, the board and counsel should build a record in anticipation of litigation if the deal is challenged in the Chancery Court. Delaware law in this area focuses on the board’s process in choosing whether to accept or reject a merger offer, and as long as the board is adequately informed, courts will grant business judgment rule protection.

2. United Kingdom: Codified Process Rules

The U.K. has similar rules regarding directors’ duties and processes during M&A transactions. Under section 172 of the Companies Act, directors of a company have a duty to act in a way “most likely to promote the success of the company for the benefit of its members [shareholders] as a whole.”\textsuperscript{106} The general rules of English common law treated “managerial conduct during takeover bids” in a manner “consistent with its general policy of defending managerial autonomy against the demands of shareholders.”\textsuperscript{107} This is the British version of the business judgment rule, which “is the law’s recognition that the courts should not, as a general rule, interfere with the way in which the board exercises its discretion to run the business.”\textsuperscript{108} Therefore, similar to in the U.S., the business judgment rule is the baseline standard of care for directors during the sale process.

The U.K. also has codified information rules within the Takeover

\textsuperscript{103} The Van Gorkom court did not make this requirement absolute, but stated that management can conduct valuation studies only in limited circumstances. \textit{Id.} at 876 (“We do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law. Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management.”).

\textsuperscript{104} \textsc{Del. Code Ann.}, tit. 8, § 141(e) (Supp. 2010).

\textsuperscript{105} \textsc{Del. Code Ann.}, tit. 8, § 141(e) (Supp. 2010). The directors should not simply take all information presented to them at face value.

\textsuperscript{106} \textsc{Companies Act}, 2006, c.46 § 172 (Eng.).

\textsuperscript{107} Johnston, \textit{supra} note 52, at 441 (citing Automatic Self-Cleansing Filter Syndicate Co. Ltd. v. Cunninghame [1906] 2 Ch. 34, CA.).

\textsuperscript{108} Johnston, \textit{supra} note 53, at 441.
Code similar to those established in Van Gorkom. Rule 3.1 requires that the “board of the [target] company must obtain competent independent advice on any offer and the substance of such advice must be made known to its shareholders.”\footnote{TAKEOVER CODE § 3.1. See also TAKEOVER CODE, Appendix § 3(1)(c).} The Takeover Code also requires that “the board is provided promptly with copies of all documents and announcements” associated with an offer.\footnote{TAKEOVER CODE, Appendix § 3(1)(a).} Directors must also hold regular board meetings throughout the process “in order to ensure that all directors are kept up-to-date with events and with actions taken.”\footnote{TAKEOVER CODE, Appendix § 3(1).} Similar to Van Gorkom and its progeny, U.K. law focuses on the board’s process during the sale of the company.

Even though derivative suits challenging deals are not filed as frequently in the U.K., directors still must build a record of their process. The Takeover Panel has statutory authority to make reasonable requests for board meeting minutes.\footnote{TAKEOVER CODE, Appendix § 3(1); COMPANIES ACT, 2006, c.46 §§ 947(1) (“The Panel may by notice in writing require a person—(a) to produce any documents that are specified or described in the notice; (b) to provide, in the form and manner specified in the notice, such information as may be specified or described in the notice.”), 947(3) (Takeover Panel can only request “documents and information reasonably required in connection with the exercise by the Panel of its functions.”) (Eng.).} Because these requests are made outside of litigation, the Companies Act does provide a professional privilege similar to the attorney-client privilege in the U.S.\footnote{COMPANIES ACT, 2006, c.46 § 947(10) (“A person is not required by this section to disclose documents or information in respect of which a claim to legal professional privilege . . . could be maintained in legal proceedings.”). See also, e.g., LA. CODE EVID. art. 506 (2006).}

In both the U.S. and the U.K., the business judgment rule is the starting point when analyzing the actions of directors during the sale of company, and courts generally give deferential treatment to directors. Also, under Van Gorkom in Delaware and the Takeover Code in the U.K., directors have a duty to be adequately informed and must seek the advice of independent financial advisors on the adequacy of the offer. Again, the focus is on the process of informing the board, not necessarily the merits of the decision. As discussed in great detail below, this is where the similarities between the substantive rules in the U.S. and U.K. end. While directors in the U.S. are given a great deal of autonomy in deciding on the merits of a deal, that decision rests solely in the hands of the shareholders in the U.K.
III. AVAILABILITY OF TAKEOVER DEFENSES

In the recent *Airgas* case, former Chancellor Allen stated, “I conclude that, as Delaware law currently stands . . . the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors.”114 This follows the “cardinal precept of the [DGCL] that directors, rather than shareholders, manage the business and affairs of the corporation.”115 Therefore, directors of Delaware corporations may use a variety of defensive mechanisms to thwart an inadequate takeover bid for the company prior to reaching a shareholder vote.116 The Delaware approach is fundamentally at odds with that taken in the U.K., where the “board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid.”117 Therefore, in the U.K., the shareholders, and not the board, ultimately decide whether to accept or reject the bid. These two policy positions have shaped substantive takeover law in these jurisdictions.

A. United States: Takeover Defenses Permitted

Delaware common law has established and recently reaffirmed target company directors’ ability to use takeover defenses in M&A.118 However, there are certain limited instances where Delaware law prohibits the use of takeover defenses.119

1. Unocal, Moran, and the Emergence of the Poison Pill

In *Unocal Corp. v. Mesa Petroleum, Inc.*, the Delaware Supreme Court established the standard for analyzing the fiduciary duty of care for directors when using takeover defenses in response to a hostile tender offer.120 “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” when using takeover defenses, the court established “an enhanced duty which calls for judicial examination at the threshold before

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115 Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (citing DEL. CODE ANN. tit. 8, § 141(a)).
116 See discussion infra Part III.A.
117 TAKEOVER CODE, General Principle 3.
118 See *Airgas*, 2011 WL 519735 at *1. See also infra Part III.A.1.
119 See infra Part III.A.2.
the protections of the business judgment rule may be conferred.”\textsuperscript{121} \textit{Unocal} established what has become known as an “enhanced business judgment rule” standard, because the board must establish more than simply a “rational basis” for its decision.\textsuperscript{122}

As a threshold matter, the board “has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders.”\textsuperscript{123} If the offer is in the best interests of the shareholders, then if the directors deploy defensive measures, they are in breach of their duty of care. Therefore, in order to establish whether the directors’ use of takeover defenses is proper, the \textit{Unocal} court created a two-prong test. First the directors must establish that the takeover bid is a threat to “corporate policy and effectiveness.”\textsuperscript{124} Directors meet this burden “by showing good faith and reasonable investigation,” which is “materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors.”\textsuperscript{125} Subsequent cases established that such a threat exists if the board can show the “inadequate price of [the bidder’s] offer, coupled with the fact that a majority of [the target’s] stockholders would likely tender into that inadequate offer.”\textsuperscript{126} In the second prong of the analysis, the board must establish that its takeover defense was “reasonable in relation to the threat posed.”\textsuperscript{127} Under \textit{Unocal}, directors can consider a number of factors in deploying takeover defenses:

This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on “constituencies” other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange.\textsuperscript{128}

If the court finds that the board’s takeover defense, based on the above factors, “is neither unlawful nor unreasonable” and the board “has acted in good faith and with due care, its decision in the absence of an abuse of

\textsuperscript{121} Id. at 954.
\textsuperscript{122} Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
\textsuperscript{123} \textit{Unocal}, 493 A.2d at 954.
\textsuperscript{124} Id. at 955.
\textsuperscript{125} Id. at 955 (citations omitted).
\textsuperscript{126} Air Prods. & Chems., Inc. v. Airgas, Inc., 2011 WL 519735 at *1 (Del.Ch. 2011).
\textsuperscript{127} \textit{Unocal}, 493 A.2d at 955.
\textsuperscript{128} Unocal, 493 A.2d at 955.
discretion will be upheld as a proper exercise of business judgment.”

The “poison pill” is the most popular and effective takeover defense used in America today. The poison pill is adopted by a simple board resolution that causes “an acquirer [to suffer] a devastating dilution in its ownership position in the event that it passes certain acquisition thresholds without the prior approval of the target’s management.” Additionally, many companies couple their use of the poison pill with a classified board. This requires a hostile bidder to “conduct a proxy contest to elect a slate of directors committed to redeeming the pill” and must do so “in two consecutive proxy contests in order to obtain a majority of the board,” which is extremely difficult. This device effectively prevents a takeover of the company without director approval. “Hundreds of firms adopted these measures after the Delaware Supreme Court upheld their legality” in Moran v. Household Int’l., Inc.

Former Chancellor Allen recently stated that the Delaware Supreme Court “made clear in Moran that ‘coercive acquisition techniques’ (i.e. the well-known two-tiered front-end-loaded hostile tender offers of the 1980s) were a legally cognizable ‘threat,’ and the adoption of a poison pill was a reasonable defensive measure taken in response to that threat.” Similar to other takeover defenses, Delaware courts apply the Unocal standard to the poison pill. Because poison pills are often adopted in advance of hostile offers, there is not a specific threat to corporate policy and effectiveness, but instead the perceived “threat in the market place of coercive two-tier tender offers” is sufficient for the board to deploy this takeover defense.

To satisfy the second prong of the Unocal test, the “range of reasonableness,” the board cannot unilaterally reject all offers. Moran established that the poison pill “is not absolute” and the board cannot

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129 Id. at 957.
130 Miller, supra note 18, at 56 (citing Moran v. Household International Inc., 500 A.2d 1346 (Del. 1985)). See also Armour & Skeel, supra note 6, at 1734 (“[T]he poison pill or shareholder rights plan, which is designed to dilute a hostile bidder's stake massively if the bidder acquires more than a specified percentage of target stock—usually 10 or 15%. Poison pills achieve this effect—or more accurately, would achieve this effect if they were ever triggered—by, among other things, inviting all of the target's shareholders except the bidder to buy two shares of stock for the price of one.”).
131 Bainbridge, Director Primacy, supra note 79, at 796.
132 Id.
133 Miller, supra note 18, at 56 (citing Moran, 500 A.2d 1346).
135 “Moran and virtually every pill case since, which have consistently applied the Unocal analysis to defensive measures taken in response to hostile bids.” Airgas, 2011 WL 519735 at *49 n.506.
136 Moran, 500 A.2d at 1356.
“arbitrarily reject the offer.”\textsuperscript{137} Instead, the board must have the ability to redeem the poison pill if a bidder presents an adequate offer.\textsuperscript{138} As stated by its inventor, Martin Lipton, “the pill was neither designed nor intended to be an absolute bar.”\textsuperscript{139} When using the poison pill, “a board cannot say ‘never,’ [to takeover bids] but it can say ‘no’ in order to obtain the best deal for its shareholders.”\textsuperscript{140} The Chancery Court recently reaffirmed this notion in \textit{Airgas}.\textsuperscript{141} Therefore, so long as the board’s use of the poison pill is reasonable, then it is a permissible takeover defense in the United States.

2. \textit{Revlon}: When Takeover Defenses are Prohibited

In \textit{Revlon v. MacAndrews & Forbes Holdings, Inc.}, the Delaware Supreme Court established that in some instances takeover defenses are not permitted.\textsuperscript{142} The court stated that in certain circumstances, the duty of the board changes from “the preservation of [the target] as a corporate entity to the maximization of the company’s value at a sale for the stockholders’ benefit.”\textsuperscript{143} As discussed below, this essentially occurs when the board is faced with multiple fair and adequate offers to purchase the company. Because the offers are adequate, under \textit{Unocal}, there is no longer a threat to “corporate policy and effectiveness” caused by an inadequate offer.\textsuperscript{144} In these situations, the “directors’ role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.”\textsuperscript{145} Therefore, when the \textit{Revlon} rule applies, if the directors deploy a takeover defense like the poison pill, the business judgment rule will not protect them, which results in a breach of their fiduciary duty of care.\textsuperscript{146}

\textsuperscript{137} \textit{Moran}, 500 A.2d at 1354 (“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 [under the \textit{Unocal} standard].”).

\textsuperscript{138} \textit{Id.} (citing \textit{Unocal}, 493 A.2d at 954–55, 958).


\textsuperscript{140} \textit{Id.}

\textsuperscript{141} “[T]his case does not endorse ‘just say never.’ What it does endorse is Delaware's long-understood respect for reasonably exercised managerial discretion, so long as boards are found to be acting in good faith and in accordance with their fiduciary duties (after rigorous judicial fact-finding and enhanced scrutiny of their defensive actions).” \textit{Air Prods. & Chems., Inc. v. Airgas, Inc.}, 2011 WL 519735 at *50.


\textsuperscript{143} \textit{Id.} at 182.

\textsuperscript{144} \textit{See Airgas}, 2011 WL 519735 at *1.

\textsuperscript{145} \textit{Revlon}, 506 A.2d at 182 (emphasis added).

\textsuperscript{146} \textit{See id.} at 185 (If “the directors allowed considerations other than the maximization of shareholder profit to affect their judgment, and followed a course that ended the auction for Revlon, absent court intervention, to the ultimate detriment of its shareholders. No such
There is a significant line of case law that determines when this Revlon duty attaches and prohibits the use of takeover defenses. When directors are faced with only one offer to purchase the company, their choice to use takeover defenses is still analyzed under Unocal.\(^\text{147}\) Under Airgas, “a board cannot be forced into Revlon mode any time a hostile bidder makes a tender offer that is at a premium to market value.”\(^\text{148}\) In fact, in situations involving only one offeror, the Revlon duty does not attach until the directors begin negotiations with that person.\(^\text{149}\) Therefore, if the board is faced with only one bid, even at a premium above the market price, the board may continue to use poison pills and other takeover defenses if it is in the best interests of the company and its shareholders.\(^\text{150}\)

The Revlon duty attaches when a “sale or breakup of the company is inevitable” or when the board initiates an active bidding process.\(^\text{151}\) In these cases, the board may not use takeover defenses, but instead “obtaining the highest price for the benefit of the stockholders should [be] the central theme guiding director action.”\(^\text{152}\) Because of changing market conditions and the unique facts surrounding each deal, courts cannot establish a “single blueprint that a board must follow to fulfill its duties.”\(^\text{153}\) However, directors easily satisfy these duties by conducting a full-blown auction process\(^\text{154}\) or a market canvass\(^\text{155}\) prior to signing the merger agreement. Absent circumstances giving rise to the Revlon duty, directors may continue to utilize takeover defenses if their use is reasonable under Unocal. This gives the board a significant amount of control over the sales process and the adequacy of offers.\(^\text{156}\)

defensive measure can be sustained when it represents a breach of the directors' fundamental duty of care. See Smith v. Van Gorkom, Del.Supr., 488 A.2d 858, 874 (1985). In that context the board's action is not entitled to the deference accorded it by the business judgment rule.”).

\(^{147}\) See supra Part III.A.1.

\(^{148}\) Airgas, 2011 WL 519735 at *51.


\(^{150}\) See id.

\(^{151}\) Paramount Commc’ns., Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1989).

\(^{152}\) Revlon, 506 A.2d at 182.

\(^{153}\) Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989). See also Lyondell, 970 A.2d at 242 (“No court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control.”).

\(^{154}\) Revlon, 506 A.2d at 182.

\(^{155}\) Barkan, 567 A.2d at 1287.

\(^{156}\) See discussion infra Part III.C.
B. United Kingdom: Takeover Defenses Strictly Prohibited

In contrast to Delaware common law, the U.K.’s Takeover Code strictly prohibits the use of takeover defenses.\(^{157}\) The common law in force before the creation of the Takeover Code applied a fiduciary duty analysis similar to the Unocal test, which allowed takeover defenses with a “proper purpose” of advancing company and shareholder interests, not those designed the secure directors’ position on the board.\(^{158}\) However, these common law rules were abrogated by the Takeover Code, which now requires that the target board “must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid.”\(^{159}\)

Rule 21.1 provides a bright line rule that prohibits the board from taking “any action which may result in any offer or bona fide possible offer being frustrated or in shareholders being denied the opportunity to decide on its merits.”\(^{160}\) Subsection (b) of this rule provides an illustrative list of specific impermissible devices, which notably includes the poison pill.\(^{161}\) U.K. directors must consult the Takeover Panel if there is any doubt as to whether any defensive action violates Rule 21.1.\(^{162}\) Because of the fear of defensive action, the target directors must consult the Takeover Panel even in advance of declaring special dividends\(^{163}\) or redeeming shares.\(^{164}\) In fact, “[a]ny director who has a question concerning the propriety of any action as far as the Code is concerned should ensure that the Panel is consulted.”\(^{165}\) Therefore, under the Takeover Code, takeover defenses are strictly

\(^{157}\) Takeover Code, R.21.1.

\(^{158}\) Johnston, supra note 52, at 436, 441. See also id. at 438 (“The validity of the decision [to use a takeover defense] turns on the facts that the court finds about the board's primary or sole purpose. If that purpose is not to maintain control in the face of an unwelcome takeover bid, but rather is part of their normal management of the affairs of the company, their actions will not be caught by this precedent and will not constitute a breach of their fiduciary duty.”).

\(^{159}\) Takeover Code, General Principle 3.

\(^{160}\) Takeover Code, R.21.1(a) (emphasis added). See also Takeover Code, R.21.1 n.3.

\(^{161}\) Takeover Code, R.21.1(b)(ii)–(iii).

\(^{162}\) Id. (“The Panel must be consulted in advance if there is any doubt as to whether any proposed action may fall within this Rule.”).

\(^{163}\) See Takeover Code, R.21.1 n.3 (“if the Target declares a dividend other than in the ordinary course this could frustrate the offer, and therefore, the Panel must be consulted. The effect of the dividend is that the equity cushion in the company is decreased, which makes it a less attractive target for the Offeror.”).

\(^{164}\) See Takeover Code, R.37.3 (“During the course of an offer, the Target cannot redeem its shares without approval of its shareholders. It can redeem shares if it is a part of a preexisting obligation, but the Board needs Panel consent.”).

\(^{165}\) Takeover Code, Appendix § 3(1).
prohibited in all circumstances, and directors are obligated to consult with the Panel to ensure their compliance with this mandate. These rules ultimately shift all authority away from the board and into the hands of the company’s shareholders, who must evaluate the adequacy of the offer and choose whether to vote in favor of the transaction.

C. Greater Director Control Encourages Negotiation and Increases Price

Empirical studies show that the U.K.’s prohibition of takeover defenses increases the number of successful hostile takeover bids. Proponents of the British system believe that this constant threat of a successful hostile takeover has positive effects on corporate governance standards. The hostile takeover is seen as an important “mechanism for rendering managers accountable to shareholders in the market for corporate control: namely, the threat that if the managers fail to maximize the share price, the company may become an acquisition target.” Therefore, in order to secure their positions on the board in a system where takeover defenses are not permitted, directors will arguably have a heightened sense of the need to maximize shareholder value.

U.K. commentators also argue that the Takeover Code’s absolute prohibition of takeover defenses creates more certainty than Unocal’s enhanced business judgment rule standard. These commentators, along with institutional investors, believe that “a long and complex factual inquiry” into directors’ motivations under a “nebulous common law test” causes “delay by litigation and possible adverse publicity.” However, a bright line rule similar to the U.K.’s may not be appropriate in all situations that may arise in deals. As stated by the Delaware Supreme Court, “the usefulness of Unocal as an analytical tool is precisely its flexibility in the face of a variety of fact scenarios. . . . The open-ended analysis mandated by Unocal is not intended to lead to a simple mathematical exercise.” This allows courts to adjust to the myriad factual scenarios that can arise in the context of a deal and permit takeover defenses when they are in the best interests of the shareholders. The Unocal standard allows Delaware courts

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166 Armour & Skeel, supra note 6, at 1738 (stating that 43% of hostile bids in the U.K. are successful compared to 24% in the U.S.).
167 Id. at 1727 (“Hostile takeovers are commonly thought to play a key role in rendering managers accountable to dispersed shareholders in the “Anglo-American” system of corporate governance.”).
168 Id. at 1728.
169 See id.
170 Johnston, supra note 52, at 443–44.
171 Id. at 442–44.
172 Paramount Commc’ns., Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989).
to strike a “balance between authority and accountability via a reasonableness standard, applied on a case-by-case basis, in which the board’s motive is what weighs most heavily.”¹⁷³

Proponents also assert that the increased frequency of successful hostile takeovers in the U.K. positively impacts the value of share ownership, arguing that once bids are “made, investors are able to exit from their holdings . . . at a considerable premium.”¹⁷⁴ Commentators taking this position argue that allowing takeover defenses means fewer takeovers, which reduces the frequency of takeover premiums.¹⁷⁵ Therefore, in their view, regulation similar to the Takeover Code “that prohibits defensive measures is required to ensure a constant supply of potential bidders.”¹⁷⁶ However, a constant supply of bidders could have adverse effects on the company and the economy as a whole.

Martin Lipton, inventor of the poison pill and one of the nation’s leading deal lawyers, stated “that proscribing the ability of companies to defend against takeovers would adversely affect long-term planning and thereby jeopardize the economy.”¹⁷⁷ He argues that the omnipresent threat of a takeover “would have a fundamental impact on the way in which corporations operate.”¹⁷⁸ This results in “no assurance of continuity,” which “would cause major disruptions in the manner in which business is now conducted.”¹⁷⁹ A business combination transaction raises issues with employee retention and can cause concern among the company’s creditors, suppliers, and customers.¹⁸⁰ The uncertainty caused by numerous takeover bids that threatens corporate productivity is limited by allowing the use of takeover defenses, which eliminates the uncertainty of potentially disruptive

¹⁷³ Bainbridge, Director Primacy, supra note 79, at 816.
¹⁷⁴ Johnston, supra note 52, at 451.
¹⁷⁶ Johnston, supra note 52, at 451.
¹⁷⁷ Martin Lipton, Takeover Bids in the Target’s Boardroom, 35 BUS. LAW. 101, 105 (1979).
¹⁷⁸ Id. at 110.
¹⁷⁹ Id. at 110. See also Lipton, Pills, Polls, and Professors, supra note 139, at 1039 (“there are very significant costs to corporations in being managed as if they are continuously for sale.”).
takeovers.\footnote{As put by Lipton, “Rather than forcing directors to consider only the short-term interests of certain shareholders, national policy requires that directors also consider the long-term interests of the shareholders and the company as a business enterprise with all of its constituencies in addition to the short-term and institutional shareholders.” Lipton, \textit{Takeover Bids in the Target’s Boardroom}, supra note 177, at 115.}

Takeover defenses like the poison pill also ensure that the board of directors will play a crucial role in the context of a takeover.\footnote{TW Servs., Inc. v. SWT Acquisition Corp., 1989 WL 20290 (Del. Ch. 1989).} Many argue that takeover defenses encourage more negotiated transactions, which ultimately may have a greater benefit to shareholders by increasing the price of the bid.\footnote{See Gregory Jackson & Hideaki Miyajima, \textit{Varieties of Capitalism, Varieties of Markets: Mergers and Acquisitions in Japan, Germany, France, the UK and USA}, RIETI Discussion Paper Series 07-E-054, at 19 (2007), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1012210 (“[I]t has been widely argued that poison pills do not necessarily frustrate the deal entirely, but lead to further negotiations and may improve the price of the bid.”).} Directors of target companies are in the best position to value the company and merger consideration because of their familiarity with the business and its operations and ability to access the most current and relevant information.\footnote{See Rosensweig, supra note 45, at 234.} Because shareholders lack the information that due diligence reveals, allowing shareholders to make the ultimate decision in all circumstances could be detrimental to their interests.\footnote{Lipton, \textit{Pills, Polls, and Professors}, supra note 139, at 1063–64.} Instead, a better system is one that allows directors to reject inadequate offers and increase the likelihood of more favorable offers.

Poison pills give directors this ability and increase the bargaining power of the board. Allowing target boards to use takeover defenses like the poison pill forces a bidder to “negotiate with the target’s board, offering terms attractive enough to convince the existing board to cancel, waive, or redeem these contingent rights.”\footnote{Dale Arthur Oesterle, \textit{The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court}, 72 \textit{Cornell L. Rev.} 117, 121 (1985). \textit{See also} Strine, \textit{Delaware’s Corporate-Law System}, supra note 80, at 1267 (Arguing that takeover defenses provide “corporate boards the ability to protect their stockholders from structurally coercive tender offers and to negotiate better offers.”).}

Without a pill in place, a bidder can bypass the board and go directly to the shareholders with a tender offer at a lower price than directors could negotiate.\footnote{See Bainbridge, \textit{Director Primacy}, supra note 79, at 808 (“If the bidder can easily bypass the board by making a tender offer, hard bargaining by the target board becomes counterproductive. It will simply lead to the bidder making a lowball tender offer to the shareholders, which they probably will accept due to the collective action problems that preclude meaningful shareholder resistance. Restricting the board’s authority to resist tender offers thus indirectly restricts its authority with respect to negotiated acquisitions.”).} By requiring these
negotiations, poison pills result in higher takeover premiums for shareholders.188 Several empirical studies testing different time periods and sample sizes of deals in the U.S. have shown that poison pills increase takeover premiums between 7.8% and 21.4%.189 Because the Takeover Code prohibits poison pills and other takeover defenses that frustrate shareholders’ ability to decide on the merits of a bid, directors of British companies do not have the same bargaining power and ability to negotiate higher premiums. Additional empirical studies support this position by revealing that the average premium paid above market price in all U.S. deals (both hostile and negotiated) is 3.8–6.4% higher than in the U.K.190 Despite the populist appeal of empowering shareholders,191 U.S. companies demand higher premiums because the American takeover regime promotes negotiated acquisitions, which lead to higher prices.192 Because directors have the ability to control the sales process through the use of takeover defenses, which ultimately leads to higher premiums for shareholders, Delaware’s rule of allowing the reasonable use of takeover defenses is superior to the U.K. Takeover Code’s absolute prohibition.

188 Robert Comment & G. William Schwert, Poison or Placebo? Evidence on the Deterrent and Wealth Effects of Modern Antitakeover Measures, 39 J. FIN. ECON. 3, 38 (1995) (“[E]vidence that takeover premiums are higher when target firms are protected by state laws or pills suggests that the relative bargaining positions of bidders and targets are altered by these antitakeover devices, raising costs to the bidders and gains to the target.”).

189 For a summary of these studies, see Guhan Subramanian, Bargaining in the Shadow of Takeover Defenses, 113 Yale L.J. 621, 637 (2003). In his essay, Subramanian recognizes that “[t]argets with pills achieve higher premiums than targets without pills.” Id. However, he questions these studies, because “virtually all targets that do not have pills have the option to put them in at any point during the takeover negotiation; thus, friendly acquisitions are generally negotiated in the “shadow” of the poison pill. Because acquirers will know this fact as well, it is unclear how to interpret the results from the pill premium studies.” See also John C. Coates, IV, Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence, 79 Tex. L. Rev. 271, 312 (2000) (recognizing that “firms that have adopted pills before a bid or other acquisition receive higher premiums than firms that have not,” but questioning the correlation between pills and higher premiums).

190 See George Alexandridis, Dimitri Petmezas & Nickoloas G. Travlos, Gains from Mergers and Acquisitions Around the World: New Evidence, 39 J. FIN. MGMT. 1671, Table II (showing that from 2000–2007, premiums in the U.S. were 3.77% higher than in the U.K.). See also Jackson & Miyajima, supra note 183, at 50 (Figure 25, which shows that from 2000–2005 the average share price premium paid over the market price four weeks prior to the announcement date of all M&A Transactions was 6.4% higher in the U.S. than in the U.K.).


192 See Rosensweig, supra note 45, at 235.
IV. AVAILABILITY OF DEAL PROTECTION DEVICES

The U.S. and U.K. also take very different approaches regarding directors’ ability to use “deal protection devices,” which are provisions within the merger agreement that ensure the deal closes.193 Because a long delay, typically several months or more, transpires between the signing of the merger agreement and the closing, bidders desire the assurance that deal protection devices provide.194

In Omnicare, Inc. v. NCS Healthcare, Inc., the Delaware Supreme Court defined deal protection devices as “any measure or combination of measures that are intended to protect the consummation of a merger transaction.”195 Deal protection devices generally limit the emergence of third-party bidders after the execution of the merger agreement, and prohibit the seller from soliciting third party offers after signing.196 Buyers often seek deal protection because of the costs associated with due diligence and the potential embarrassment that results from their offer being jumped.197 Targets utilize deal protection devices to reduce the risk of withdrawal of a favorable offer to purchase the company.198 Directors may also use these provisions as leverage to negotiate a higher purchase price, which results in a greater premium for the company’s shareholders.199 As discussed below, compared to Delaware jurisprudence, the U.K.’s Takeover Code

193 Afra Afsharipour, Transforming the Allocation of Deal Risk Through Reverse Termination Fees, 63 VAND. L. REV. 1161, 1175 (2010) (“These deal protection devices are woven into the covenants, conditions, and termination sections of the agreement.”).

194 See Stephen M. Bainbridge, Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions, 75 MINN. L. REV. 239, 241 (1990) (hereinafter Bainbridge, Exclusive Merger Agreements). See also Christina M. Sautter, Rethinking Contractual Limits on Fiduciary Duties, 38 FLA. ST. L. REV. 55, 63–67 (2011) (hereinafter Sautter, Contractual Limits on Fiduciary Duties) (discussing the factors that delay the closing of a transaction, including stockholder approval, regulatory approvals, and required third party consents).


196 Afsharipour, supra note 193, at 1175.

197 See Christina M. Sautter, Shopping During Extended Store Hours: From No Shops to Go-Shops—The Development, Effectiveness, and Implications of Go-Shop Provisions in Change of Control Transactions, 73 BROOK. L. REV. 525, 532 (2008) (hereinafter Sautter, No Shops to Go-Shops). See also Heath Price Tarbert, Merger Breakup Fees: A Critical Challenge to Anglo-American Corporate Law, 34 L. & Pol’y INT’L BUS. 627, 632 (2003) (stating that transaction costs including “expert analysis, due diligence reports by lawyers, and fairness opinions by investment bankers . . . can cost an acquirer millions.”); Eleonora Gerasimchuk, Stretching the Limits of Deal Protection Devices: From Omnicare to Wachovia, 15 FORDHAM J. CORP. & FIN. L. 685, 687 (“If the deal is not completed, the initial bidder may suffer a decrease in its own stock price and may be viewed as weak in the market for corporate control.”).

198 Tarbert, supra note 197, at 633.

199 See discussion infra Part IV.C.
significantly limits directors’ ability to use deal protection devices and will prohibit their use in the near future.

There are several deal protection devices that are commonly used to ensure the consummation of a merger. One of the most common and effective is the no-shop provision. No-shop provisions prohibit a target’s board from actively soliciting bids after entering into a definitive agreement with an initial acquirer. Typically, the target also cannot provide any material non-public information to third parties. No-shop provisions are typically paired with a “fiduciary out” that allows the target’s board to provide due diligence materials to and negotiate with a third party that makes an unsolicited offer to purchase the company. The fiduciary out also allows the target’s board to accept and unsolicited third party offer if doing so is necessary to avoid breaching its fiduciary duties.

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200 Sautter, No Shops to Go-Shops, supra note 197, at 534.
201 Section 5.6(a) of the September 26, 2010 Agreement and Plan of Merger between Southwest Airlines Co. and AirTran Holdings, Inc. provides an example of a no-shop provision:

AirTran shall not . . . (i) solicit, initiate, endorse, or knowingly encourage or facilitate (including by way of furnishing non-public information) any inquiry, proposal, or offer or afford access to the employees, business, properties, assets, books, or records of AirTran or any of the AirTran Subsidiaries, with respect to the making or completion of any Acquisition Proposal, (ii) engage in, continue, or otherwise participate in any discussions . . . or negotiations regarding, or furnish to any Person any non-public information or data with respect to, any Acquisition Proposal, or (iii) resolve, propose, or agree to do any of the foregoing.

AirTran Holdings, Inc., Current Report, (Form 8-K, Exhibit 2.1) § 5.6(a) (September 26, 2010) (hereinafter “Southwest-Airtran Merger Agreement”).

202 See Sautter, No Shops to Go-Shops, supra note 197, at 534. For an example of a fiduciary out provision, see Southwest-AirTran Merger Agreement, supra note 201, at § 5.6(b):

Notwithstanding anything to the contrary in Section 5.6(a) [the no-shop provision], if at any time following the date of this Agreement and prior to obtaining the AirTran Stockholder Approval, AirTran receives a bona fide written Acquisition Proposal that was not solicited or initiated on or after the date of this Agreement in violation of Section 5.6(a), and if the AirTran Board . . . determines in its good faith judgment, after consulting with [financial advisors and outside legal counsel] that such Acquisition Proposal constitutes or could reasonably be expected to lead to a Superior Proposal and that there is a reasonable probability that the failure to take such action would cause the AirTran Board to violate its fiduciary duties to AirTran and its stockholders under Nevada Law, AirTran and its Representatives may (x) furnish . . . information and data (including non-public information) with respect to AirTran . . . and (y) engage in, maintain, and participate in discussions or negotiations with the Person or Persons making such Acquisition Proposal . . . .

203 See Sautter, No Shops to Go-Shops, supra note 197, at 534. See also Celia R.
outs allow directors to act in the best interests of the shareholders, terminate a pre-existing merger agreement, and accept an unsolicited superior proposal should one materialize.204

The majority of merger agreements in the U.S. also include termination fee provisions.205 Under certain circumstances, the target company pays termination fees to the buyer if the target terminates the merger agreement prior to closing.206 The amount of the termination fee is usually expressed as a percentage of the purchase price in the merger agreement and averages 3.8% in the U.S.207 Similar to no-shop provisions, termination fees also have a deterrent effect on potential third party bidders, because rational target companies will only accept offers in excess of the consideration under the preexisting merger agreement plus the termination fee.208 Another customary deal protection provision provides matching rights, which allow the bidder to match a superior proposal within a specified period of time, usually two to three business days.209

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Taylor, “A Delicate Interplay”: Resolving the Contract and Corporate Law Tension in Mergers, 74 Tul. L. Rev. 561, 615 n.346 (1999) (stating that the fiduciary out’s “general intent is to give target directors the right to terminate a merger agreement if the directors believe that a change in circumstances has occurred after director approval such that an alternative course of proceeding is required by their corporate fiduciary duties.”).

204 See Sautter, Contractual Limits on Fiduciary Duties, supra note 194, at 73.

205 Afsharipour, supra note 193, at 1179.

206 See Afsharipour, supra note 193, at 1179 (“These circumstances generally encompass a failure to close the transaction because (1) the seller's board terminates the agreement in order to accept a competing offer; (2) the seller's board changes its recommendation in favor of the transaction and the buyer elects to terminate the merger agreement rather than proceed with the shareholder vote; or (3) the transaction fails for some other specified reason, such as being voted down by the seller's shareholders after a competing proposal has been announced and is agreed to or closed within a specified period of time (ranging from six to eighteen months).”).

207 Micah S. Officer, Termination fees in mergers and acquisitions, 69 J. Fin. Econ. 431, 441 (2003) (“Target termination fees as a percentage of total deal value (the total of the cash and securities offered to target shareholders) average 3.80%.”) See also Sautter, No Shops to Go-Shops, supra note 197, at 536 (stating that termination fees range from 1–5% of deal value).

208 See Afsharipour, supra note 193, at 1179.

209 See Gerasimchuk, supra note 197, at 692. For an example of a recommendation out, see Southwest-AirTran Merger Agreement, supra note 201, at § 5.6(c):

[I]n the case of any Adverse Recommendation Change that is the result of a Superior Proposal . . . no such termination of this Agreement . . . may be made until after the third Business Day following Southwest's receipt of written notice from AirTran advising Southwest that AirTran intends to terminate this Agreement . . . and specifying the relevant terms and conditions of (including the identity of the Persons making the Superior Proposal) the Superior Proposal that is the basis of the proposed action by the AirTran Board . . . [and] the AirTran Board shall not make such an Adverse Recommendation Change and AirTran shall not
knowledge in the market that these matching rights exist, third parties will be reluctant to present any offer due to a potential matching bid by the acquirer under the pre-existing merger agreement.\footnote{210}

Merger agreements also commonly feature several other deal protection devices. As discussed above, under section 251(c) of the DGCL, the board of directors of the target company must adopt a resolution approving the merger agreement and declaring its advisability.\footnote{211} Most merger agreements contain a board recommendation provision, which contractually obligates the board of directors to recommend that the transaction is in the best interests of the company and its shareholders.\footnote{212}

Board recommendation provisions are usually paired with a fiduciary out provision, which is known in this context as a “recommendation out.”\footnote{213}

With a recommendation out in place, a board can withdraw its resolution recommending the transaction despite its contractual obligation to favorably

\begin{quote}
terminate this Agreement if, prior to the expiration of such three Business Day period . . . Southwest makes a proposal to adjust the terms and conditions of this Agreement that the AirTran Board determines in good faith (after consulting with and receiving the advice of outside legal counsel and the AirTran Financial Advisor) to be at least as favorable to AirTran and its stockholders as the Superior Proposal.
\end{quote}

\footnote{210} \textit{See} Gerasimchuk, \textit{supra} note 197 at 692.

\footnote{211} DEL. CODE ANN. tit. 8, § 251(b) (Supp. 2011). \textit{See also supra} Part II.A.1.

\footnote{212} For an example of a board recommendation provision, \textit{see} Southwest-AirTran Merger Agreement, \textit{supra} note 201, at § 5.6(c):

\begin{quote}
The AirTran Board shall not (i) (A) fail to make the Recommendation [that the transaction is in the best interests of AirTran and its stockholders] to the stockholders of AirTran . . . (B) adopt, approve, recommend, endorse, or otherwise declare advisable the adoption of any Acquisition Proposal, or (C) resolve, agree, or publicly propose to take any such actions.
\end{quote}

\footnote{213} \textit{See} Sautter, \textit{Contractual Limits on Fiduciary Duties}, \textit{supra} note 194, at 80–87 (discussing the various forms of recommendation outs). For an example of a recommendation out, \textit{see} Southwest-AirTran Merger Agreement, \textit{supra} note 201, at § 5.6(c):

\begin{quote}
Notwithstanding the foregoing, at any time prior to obtaining the AirTran Stockholder Approval, the AirTran Board may make an Adverse Recommendation Change: (i) if an event, fact, circumstance, or occurrence, or combination or series thereof, that was not known to the AirTran Board as of the date of this Agreement becomes known to the AirTran Board (an “Intervening Event”) or (ii) in response to a Superior Proposal . . . if, and only if, the AirTran Board determines in good faith (after consulting with and receiving the advice of outside legal counsel) that there is a reasonable probability that the failure to do so would cause the AirTran Board to violate its fiduciary duties to AirTran and its stockholders under Nevada Law, and after such Adverse Recommendation Change AirTran may terminate this Agreement . . . .
recommend the deal to its shareholders. Some merger agreements also contain “force-the-vote” provisions, which require the board of directors to submit the agreement to its shareholders for a vote, even if the board has withdrawn its recommendation. As their name suggests, all deal protection devices discourage potential competing third party bidders, which increases the likelihood that the deal will close. As displayed in the following sections, the permissibility of these provisions varies greatly between the U.S. and U.K.

A. United States: Deal Protection Analyzed under the Unocal Standard

In the United States, the Delaware courts have generally held that deal protection devices are permissible, but they are subject to enhanced judicial scrutiny beyond the business judgment rule. In Paramount v. Time, the Delaware Supreme Court established that the adoption of deal protection devices “alone does not trigger Revlon . . . such devices are properly subject to a Unocal analysis.” Delaware courts use the Unocal analysis because the “board’s decision to protect its decision to enter a merger agreement with defensive devices against uninvited competing transactions that may emerge is analogous to a board’s decision to protect against dangers to corporate policy and effectiveness when it adopts defensive measures in a hostile takeover contest.” When analyzing deal protection devices under Unocal’s first prong, the Delaware Supreme Court in Omnicare, Inc. v. NCS Healthcare, Inc. determined that the “threat to corporate policy and effectiveness” is “the possibility of losing the [current] offer and being left with no comparable alternative transaction.” The second Unocal prong requires the deal protection device to be “reasonable in relation to the threat posed.” For the deal protection device to be reasonable, the directors must “establish that the merger deal protection devices adopted in response to the threat were not ‘coercive’ or ‘preclusive,’ and then demonstrate that their response was within a ‘range of reasonable responses’ to the threat perceived.”

214 See Sautter, Contractual Limits on Fiduciary Duties, supra note 194, at 58.
215 Id. at 63.
216 See supra Part II.B.1 (discussing the business judgment rule standard in the U.S.).
219 Id. at 935.
220 Id.
221 Id. (“A response is “coercive” if it is aimed at forcing upon stockholders a management-sponsored alternative to a hostile offer. A response is “preclusive” if it deprives stockholders of the right to receive all tender offers or precludes a bidder from seeking control by fundamentally restricting proxy contests or otherwise.”) (citing Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387–88 (Del.1995)).
Delaware courts generally find that no-shop provisions are reasonable, and therefore permissible under the Unocal standard. In Phelps Dodge Corp. v. Cyprus Amax Minerals Co., the Chancery Court set forth the requirement that in order to fall within the Unocal “range of reasonableness” standard, no-shop provisions must be paired with a fiduciary out that allows the board to consider a superior proposal.\(^{222}\) Without the presence of a fiduciary out, a no-shop provision effectively forecloses the target company from providing any non-public information to or negotiating with a third party, which could lead to a superior proposal and benefit the company’s shareholders.\(^{223}\) As stated by former Chancellor Allen in Phelps Dodge, such action by directors “is the legal equivalent of willful blindness, a blindness that may constitute a breach of a board’s duty of care.”\(^{224}\) Additionally, under the fiduciary out provision, a board cannot contract away its fiduciary duty of care and delegate the decision of whether the board should consider a potentially superior proposal to a third party.\(^{225}\) The fiduciary out can, and often does, require that the board consult financial advisors and outside legal counsel.\(^{226}\) However, as stated by the Chancery Court in Ace Ltd. v. Capital Re Corp., the board of directors of a target company has a “duty to determine what its own fiduciary obligations require at precisely that time in the life of the company when the board's own judgment is most important,” which includes the sale of company.\(^{227}\) Therefore, in the U.S., no-shop provisions are permissible if they are paired with a fiduciary out that leaves all decision-making authority with the board of directors.

Delaware courts also treat termination fees favorably and analyze their reasonableness in terms of the percentage of the merger consideration. Dicta in Phelps Dodge stated that a 6.3% termination fee “seems to stretch the definition of range of reasonableness and probably stretches the definition beyond its breaking point.”\(^{228}\) Therefore, U.S. companies generally use lower termination fees, which average 3.4–3.8% of the merger consideration.\(^{229}\)

\(^{222}\) Phelps Dodge Corp. v. Cyprus Amax Minerals Co., 1999 WL 1054255 at *2 (Del. Ch. 1999).

\(^{223}\) See id.

\(^{224}\) Id.

\(^{225}\) See Sautter, Contractual Limits on Fiduciary Duties, supra note 194, at 76–77.

\(^{226}\) See, e.g., Southwest-AirTran Merger Agreement, supra note 201, at § 5.6(b).

\(^{227}\) Ace Ltd. v. Capital Re Corp., 747 A.2d 95, 106 (Del. Ch. 1999).

\(^{228}\) Phelps Dodge, 1999 WL 1054255, at *2.

\(^{229}\) See Officer, supra note 207, at 441 (study shows reveals a mean of 3.8% for termination fees in U.S. deals between 1988 and 2000. See also Jin Q. Jeon, How Much is Reasonable? The Size of Termination Fees in Mergers and Acquisitions, working paper, Department of Economics, Finance and Legal Studies, University of Alabama, at 17 (2009)
Similar to termination fees, Delaware courts treat matching rights favorably. In *In re Toys "R" Us, Inc. S'holder Litig.*, the Chancery Court stated that “neither a termination fee nor a matching right is per se invalid. Each is a common contractual feature that, when assented to by a board fulfilling its fundamental duties of loyalty and care for the proper purpose of securing a high value bid for the stockholders, has legal legitimacy.”

Therefore, matching rights are valid deal protection devices in U.S. merger agreements. Board recommendation provisions, which contractually obligate directors to recommend the deal to its shareholders, are also generally permissible. However, Delaware courts have not examined how narrowly an accompanying recommendation out provision may be drafted while still meeting the reasonableness standard. Delaware law also authorizes directors to use force-the-vote provisions. Under section 146 of the DGCL, the board may send a merger “to a vote of its stockholders whether or not the board of directors determines at any time subsequent to approving [the merger] that [the merger] is no longer advisable and recommends that the stockholders reject or vote against the matter.” As displayed in this section, Delaware corporate law makes a variety of deal protection devices available to directors of target companies.

When examining a merger agreement, Delaware courts do not determine the reasonableness of each isolated deal protection device, but instead they examine deal protection devices in the aggregate and in light of their interaction with one another. The Delaware courts’ use of the *Unocal* standard gives directors the ability to choose whether deal protection devices will benefit the corporation and its shareholders. This flexible approach allows directors to tailor the merger agreement to fit the specific needs of the deal.

(similar study shows a mean of 3.407% for termination fees in U.S. deals between January 2001 and December 2007, available at: http://acumen.lib.ua.edu/content/u0015/0000001/0000031/u0015_0000001_0000031.pdf.)

230 *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1017 (Del. Ch. 2005). *See also In re Smurfit-Stone Container Corp. S'holder Litig.*, 2011 WL 2028076, *21, *21 n.141 (Del. Ch. 2011) (discussing the reasonable and customary use of matching rights); *In re Dollar Thrifty S'holder Litig.*, 14 A.3d 573, 615 (Del. Ch. 2010) (holding that the board’s use of various deal protection devices, including matching rights, was reasonable).

231 *See supra* note 212 and accompanying text.

232 *See* Sautter, *Contractual Limits on Fiduciary Duties*, *supra* note 194, at 59 (“To date, the Delaware courts have never directly addressed the validity of provisions limiting merger recommendation fiduciary outs to Superior Offers and/or Intervening Events.”).

233 *See In re Cogent, Inc. Shareholder Litigation*, 7 A.3d 487, 509 (Del. Ch. 2010) (examining the reasonableness of deal protection devices in the aggregate).

234 *See* Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919, 923 (2001) (advocating the “inescapable
B. United Kingdom: Recent Amendments Prohibit Deal Protection Devices

The U.K.’s Takeover Panel is not nearly as receptive of deal protection devices as the Delaware courts. On July 21, 2011, the Panel’s Code Committee revised the Takeover Code to generally prohibit the use of all deal protection devices. These amendments, which take effect on September 19, 2011, will amplify the differences between British and American deal activity. Because deal protection devices generally have a deterrent effect on third party offers, the Panel’s aversion to them is consistent with the general policy that shareholders should not be “denied an opportunity to decide on the merits” of a transaction.

Prior to the July 2011 revision, Rule 21.2 of the Takeover Code permitted the use of “de minimis” termination fees. The Code formerly provided that if a termination fee exceeded 1% of the purchase price in the merger agreement, it is no longer de minimis. The Code set this 1% limit because the Panel took the position that termination fees should only compensate for due diligence and transaction costs, and not “prevent the possible payment of an inducement fee from frustrating a competing bid.” Despite the restrictions on termination fees, the Takeover Code formerly permitted the use of other deal protection devices. Therefore, with the exception of termination fees, “the Code [did] not specifically restrict or prohibit such deal protection measures.”

However, the Panel’s Code Committee recently drafted provisions that “prohibit deal protection measures and [termination] fees other than in certain limited cases.” These revisions prohibit directors of target
companies from entering into agreements “to refrain from taking any action which might facilitate a competing transaction.”243 To achieve this result, the amendments to Rule 21.2 of the Code generally bar target companies from entering into an “offer-related arrangement” with a potential acquirer,244 which is intended to encompass all deal protection devices as defined by the Code Committee.245 The Committee’s definition of deal protection devices includes “provisions intended to restrict the board of the offeree company from soliciting competing offers (sometimes referred to as “no shop” provisions).”246 Therefore, the revised Takeover Code prohibits no-shop provisions. The revision also prohibits board recommendation provisions that restrict the target’s board from changing its recommendation regarding the transaction for a fixed period of time.247 Additionally, the Code Committee has barred force-the-vote provisions248 and matching rights249 in the revised version of the Takeover Code.

The amendment to Rule 21.1 also expressly prohibits “any [termination] fee arrangement or other arrangement having a similar or comparable financial or economic effect.”250 In the eyes of the Committee, termination fees and the above listed deal protection devices “deter competing offerors from making an offer, thereby denying offeree company shareholders the possibility of deciding on the merits of a competing offer.”251 Therefore, the Panel, through the Code Committee, has revised the Takeover Code and prohibited the use of all deal protection devices, including termination fees.

C. Deal Protection Devices Increase Shareholder Premiums

The impact of deal protection devices cannot be analyzed in a vacuum and without consideration of other factors influencing a deal,

243 Id. at § 5.16(i).
245 See PCP 2011/1, supra note 241, at § 3.6 (“The proposed general prohibition, formulated in this way, is intended to prohibit . . . any deal protection measure of the kind identified in PCP 2010/2.”).
246 See PCP 2010/2, supra note 244, at § 9.19(c).
247 See id. at § 9.19(e).
248 See id. at § 9.19(b).
249 See id. at § 9.19(f).
250 See Instrument 2011/2, supra note 244, R.21.2(b).
251 Panel Statement 2010/22, supra note 242, at § 5.14(i).
including takeover defenses. In the U.K., the decision by the Takeover Panel’s Code Committee to prohibit deal protection devices is consistent with the Takeover Code’s prohibition of takeover defenses and its general policy as a whole. In its view, deal protection devices leave “little, if any, room for the board of an offeree company to facilitate or recommend a competing offer, thereby frustrating bids by potential competing offerors.” Because of their deterrent effect, deal protection devices are “contrary to the spirit of Rule 21 and General Principle 3,” which require that the “board of an offeree company must act in the interests of the company as a whole and must not deny the holders of securities the opportunity to decide on the merits of the bid.”

According to the Code Committee, deal protection provisions “are often presented to offeree company boards by offerors and their advisers as standard ‘packages’ which the offeree company board is under considerable pressure to accept, with little, if any, room for negotiation.” The Committee further suggests that these deal protection devices restrict “the ability of the offeree company board to engage with potential competing offerors in a way that is detrimental to the interests of offeree company shareholders.” However, the detrimental effects of deal protection devices in the U.K. could be a product of the system in which they operate.

Devoid of the ability to use takeover defenses, directors of U.K. target companies are left in a position with little bargaining power. Because the board cannot take action that may lead to an offer being “frustrated or in shareholders being denied the opportunity to decide on its merits,” directors of target companies have no power to negotiate deal protection devices on favorable terms. When the target board is forced, under the Takeover Code, to send the offer through to a shareholder vote, it has no negotiating leverage. Leaving directors of target companies powerless in this situation can adversely affect the company. For example, a target could receive several offers, all of which are deemed insufficient through shareholder vote, which results in the repeated payment of a termination fee to the bidder. The poison pill and other takeover defenses prevent this scenario in the U.S., but it may come to fruition in the U.K. because of the prohibition of takeover defenses. The Code Committee recognized this and decided to generally prohibit the use of deal protection devices in the U.K. Even though this may be the appropriate course of action in the U.K., the

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252 PCP 2010/2, supra note 244, at § 9.1.
253 PCP 2010/2, supra note 244, at § 9.1.
254 TAKEOVER CODE, General Principle 3.
256 Panel Statement 2010/22, supra note 242, at § 3.1(vi).
ability to use deal protection devices in conjunction with takeover defenses in the U.S. is in the best interests of the corporation and its shareholders.

By empowering American directors with the ability to reasonably use takeover defenses and deal protection devices, Delaware law provides directors with the flexibility needed to act in the best interests of shareholders and adjust to the dynamics surrounding the deal. As stated by the Chancery Court in *Toys “R” Us*:

That reasonableness inquiry does not presume that all business circumstances are identical or that there is any naturally occurring rate of deal protection, the deficit or excess of which will be less than economically optimal. Instead, that inquiry examines whether the board granting the deal protections had a reasonable basis to accede to the other side’s demand for them in negotiations. In that inquiry, the court must attempt, as far as possible, to view the question from the perspective of the directors themselves, taking into account the real world risks and prospects confronting them when they agreed to the deal protections. As *QVC* clearly states, what matters is whether the board acted reasonably based on the circumstances then facing it.258

Using this realistic approach, instead of bright line rules, the reasonableness standard of the Delaware courts allows directors of target companies to act appropriately and use deal protection devices to the shareholders’ advantage, while still holding directors accountable for unreasonable use of deal protection contrary to their fiduciary duties.

Similar to Lipton’s argument advocating the use of takeover defenses, deal protection devices can also eliminate the disruptive effects to corporations and the economy in general caused by the uncertainty resulting from M&A activity.259 Commentators argue that deal jumping multiplies these disruptive effects, and therefore, it “is in the corporation’s interest to have as much certainty in a business combination as possible; announcement of successive transactions (combination with Company A, followed by announcement that the combination will in fact be with Company B, etc.) can wreak havoc.”260 Therefore, deal protection devices that eliminate this uncertainty are desirable.

258 In re *Toys “R” Us*, Inc. Shareholder Litigation, 877 A.2d 975, 1016 (Del. Ch. 2005) (citing Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1993)).

259 See Lipton, *Takeover Bids in the Target’s Boardroom*, supra note 177 at 105, 110.

Termination fees and other deal protection devices, in many situations, may also induce additional bids to acquire the company.\textsuperscript{261} The announcement of a merger agreement that includes deal protection devices could signal to the market that a company is an attractive target and stimulate multiple offers.\textsuperscript{262} In an auction situation, deal protection devices also encourage bidders to make their best offers.\textsuperscript{263} Because these provisions “make it difficult for a competing bidder to make a subsequent topping bid, each bidder will have an incentive to make its best bid.”\textsuperscript{264} Therefore, in many instances, deal protection devices induce serious bids instead of foreclosing them.

Deal protection devices also arm target boards with a bargaining chip that enables them to negotiate a higher price in the deal and enhances value for the shareholders.\textsuperscript{265} Stated in the negative, the absence of deal protection within a merger agreement could cause a bidder to offer a discounted price to account for the risk of non-consummation of the deal.\textsuperscript{266} Several empirical studies have examined the effect of termination fees on

\textsuperscript{261} Tarbert, supra note 197, at 664. See also Sean J. Griffith, The Costs and Benefits of Precommitment: An Appraisal of Omnicare v. NCS Healthcare, 29 J. CORP. L. 569, 613 (2004) (Arguing deal protection “may be necessary to bring a would-be acquiror to the bargaining table. . . . Without the ability to do so, targets may not be able to entice would-be acquirors to begin negotiations, leaving targets with a lesser (and potentially worse) set of options.”); Officer, supra note 207, at 456; Audra L. Boone & J. Harol Mulherin, Do Termination Provisions Truncate the Takeover Bidding Process?, 20 REV. FIN. STUD., 461, 465 (2007) (“By providing compensation in the event that the target is acquired by another bidder, termination provisions are a contractual means to induce participation in the takeover process.”).

\textsuperscript{262} Tarbert, supra note 197, at 664.

\textsuperscript{263} Sparks & Nachbar, supra note 180, at 503.

\textsuperscript{264} Id. See also Paul Povel & Rajdeep Singh, Takeover Contests with Asymmetric Bidders, 19 REV. FIN. STUD., 1399, 1425 (2006) (“[T]he possibility of an exclusive deal encourages the better-informed bidder to reveal a high willingness to pay (and then pay a high price. . . . Our results also show why shareholder value maximizing target boards should in practice make frequent use of deal protection devices.”).

\textsuperscript{265} See Stephen M. Bainbridge, Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills, 29 J. CORP. L. 1, 24 (asserting that deal protection devices “give the target's board of directors a useful negotiating tool. In return for reducing the risk of nonconsummation, they can be used to extract a higher price from the bidder.”). See also Bainbridge, Exclusive Merger Agreements, supra note 194, at 285; Griffith, supra note 259, at 613; Thomas W. Bates & Michael L. Lemmon, Breaking Up is Hard to Do? An Analysis of Termination Fee Provisions and Merger Outcomes, 69 J. FIN. ECON., 469, 472 (2003) (Arguing that deal protection devices “improve the contracting environment and enhance the value of targets in negotiated corporate takeovers.”).

\textsuperscript{266} See Bainbridge, Exclusive Merger Agreements, supra note 194, at 285 (“[B]ecause rational bidders presumably discount their bids to account for the risk that the target board will renege, decreasing this risk through the use of [deal protection devices] should automatically offset any such tendency). See also Griffith, supra note 261, at 614.
negotiated acquisitions and found that deals including termination fees have significantly higher completion rates and larger deal premiums.267 These studies show that the presence of target termination fee provisions increases the probability of deal completion by 15–20%.268 By providing for a termination fee within the merger agreement, the target board gives the acquirer a greater assurance that the deal will close, and therefore is in a better bargaining position when it comes to price. These same studies also show that bid premiums are between 4–6% higher in deals that include target termination fees compared to deals that do not.269 This data supports the argument that termination fees improve the bargaining power of target directors, which leads to increased premiums for shareholders.270 Because of the improved bargaining position resulting from the use of deal protection devices coupled with takeover defenses, directors of U.S. companies have the ability to negotiate higher premiums for their shareholders. By empowering directors of target companies with these devices, the substantive rules in the U.S. generate greater value and premiums for shareholders than those found in the U.K.

CONCLUSION

The availability of takeover defenses and deal protection devices gives directors of U.S. target companies the ability to adapt to the unique circumstances surrounding each deal and generate higher premiums for shareholders in M&A transactions compared to their colleagues in the U.K. Because Delaware corporate law empowers them with these tools, directors of U.S. target companies have more negotiating power and control over the sale of the company, which ultimately leads to increased premiums for shareholders. The use of a malleable reasonableness standard allows directors to act appropriately depending on the facts and circumstances surrounding a deal, while also allowing courts to hold directors accountable

267 See Bates & Lemmon, supra note 265; Officer, supra note 202.
268 See Bates & Lemmon, supra note 265, at 484 (“[T]he presence of target termination fee provisions increases the probability of deal completion by approximately 15.5%.”); Officer, supra note 207, at 433 (“[T]arget termination fees increase the likelihood that the deal is successfully completed by almost 20% on average.”).
269 See Bates & Lemmon, supra note 265, at 494 (“[B]id premiums are between 3.7% and 6.3% higher in deals that include target termination fees compared to deals that do not.”); Officer, supra note 207, at 433 (“[T]arget termination fee use is associated with approximately 4% higher takeover premiums after controlling for correlated deal characteristics.”).
270 See Bates & Lemmon, supra note 265, at 502 (“[T]arget fees improve the bargaining position of target managers . . .”); Officer, supra note 207, at 435 (“[T]arget managers appear to be able to improve their bargaining position and extract higher premiums from bidders through the use of a target termination fee.”).
under a fiduciary duty analysis. The substantive rules developed through the Delaware common law and the DGCL place the ultimate power and authority in the hands of the board of directors during the sale of the company.

This is in stark contrast to the bright line rules of the U.K.’s Takeover Code, which strip the board of any ability to use takeover defenses and now prohibits the use of deal protection devices. Instead, the authority to decide on the merits of a transaction rests solely with the shareholders of the company. By eliminating these devices, the revised Takeover Code significantly reduces the negotiating power of the board. Empirical studies have shown that the availability of takeover defenses and deal protection devices ultimately allow directors to negotiate higher priced deals. Therefore, U.S. has the superior regime, which allows directors to divert the flow of offers into a negotiated acquisition process and generate additional value for the company’s shareholders.