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HOW TO PREVENT HARD CASES FROM MAKING BAD LAW: BEAR STEARNS, DELAWARE, AND THE STRATEGIC USE OF COMITY

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Edward Rock^{**}

ABSTRACT

The Bear Stearns–J.P. Morgan Chase merger placed Delaware between a rock and a hard place. On the one hand, the deal’s unprecedented deal protection measures—especially the 39.5% share exchange agreement—were probably invalid under current Delaware doctrine because the measures rendered the Bear Stearns shareholders’ approval rights entirely illusory. On the other hand, were a Delaware court to enjoin a deal brokered by the Federal Reserve and the Treasury Department, and arguably necessary to prevent a collapse of the international financial system, it would invite just the sort of federal intervention that would undermine Delaware’s role as the de facto provider of U.S. corporate law.

Faced with a choice between undermining the delicate and subtle balance struck between managers and shareholders and standing in the way of the imperatives of national and international economic policy, Delaware found a third way that avoided both horns of the dilemma: it took advantage of a pending New York action to stay the Delaware action and avoid making a decision. In this Essay, we tell this story, analyzing the doctrinal issues under Delaware corporate and procedural law, and discussing the implications of this episode for our understanding of the landscape of U.S. corporate lawmaking.

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INTRODUCTION

Over half of the publicly traded corporations in the United States are incorporated in Delaware. No other state even comes close.¹ Under the “internal affairs” rule, the law of the state of incorporation governs the internal affairs of the corporation—the rules of corporate decision making; the allocation of power between shareholders, directors, and management; and fiduciary duties²—and other states often look to Delaware law in fashioning their own rules.³ Delaware, one of the smallest states in the nation, has thus become the de facto national lawmaker for corporate law.⁴

Yet, Delaware’s dominant position in corporate law could be eroded. The Securities and Exchange Commission encroaches from a variety of directions.⁵ Congress could enact a national corporate law. Other states could displace Delaware, just as Delaware displaced New Jersey nearly 100 years ago.⁶

Delaware has so far been successful in fending off these potential threats. To be sure, our colleague Mark Roe has expounded the view that Delaware enjoys little autonomy in devising its corporate law because it must constantly respond to the threat of federal preemption.⁷ We have argued that the relationship is far more complementary than Roe suggests.⁸ But, regardless of whether Roe or we are right about the extent of Delaware’s legal autonomy, it is clear that, from a business perspective, Delaware is a stunning success:

¹ See Lucian Arye Bebchuk & Alma Cohen, *Firms’ Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 386 (2003); Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1560 (2002); Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, 22 J.L. ECON. & ORG. 340, 349 (2006); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the “Race” Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1804 (2002).

² 18 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 43.72 (perm. ed., rev. vol. 2007).

³ Mullen v. Acad. Life Ins. Co., 705 F.2d 971, 973 n.3 (8th Cir. 1983) (“[C]ourts of other states commonly look to Delaware law . . . for aid in fashioning rules of corporate law.”).

⁴ Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1574 (2005).

⁵ Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588, 592 (2003).

⁶ Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 727 (2002).

⁷ Roe, *supra* note 5, at 640.

⁸ See Kahan & Rock, *supra* note 4, at 1578; see also Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1771 (2006) (stating that “a symbiotic relationship between Delaware and the federal regulators” exists).

Delaware earns more than \$550 million per year in franchise taxes;⁹ these fees amount to more than 20% of its annual tax revenues;¹⁰ Delaware's market share of public corporations has increased from 30% for firms that went public between 1960 and 1964, to 56% for firms that went public between 1980 and 1984, to 77% for firms that went public between 1995 and 1998;¹¹ and no other state attracts more than a nominal percentage of public corporations that are not headquartered in the state.¹² Until now, at least, any federal encroachment on Delaware's autonomy may have hurt its pride, but not its pocketbook.

Yet it remains true that there is no assurance that the goose that lays Delaware's golden eggs will live forever. As we have argued elsewhere, the biggest threat facing Delaware is the emergence of some major crisis that focuses public attention on the peculiar mode of U.S. corporate lawmaking—in which the elected officials and judges of one of the smallest states set the rules governing most publicly traded corporations—and undermines the public faith in Delaware's ability to handle the job.¹³

The recent events leading to the demise of Bear Stearns thus presented a problem for Delaware. The shareholder litigation challenging J.P. Morgan Chase's (J.P. Morgan) acquisition of Bear Stearns caught Delaware between a rock and a hard place. How does Delaware respond when it finds itself with a choice between picking a fight it cannot win and maintaining the integrity of the fabric of Delaware corporate law?

Delaware came up with a wonderful answer: let New York decide! As we describe in this Essay, when faced with a set of deal protection measures that raised serious problems under Delaware law, Delaware managed what one might have thought impossible—it avoided a fight and also avoided undermining its nuanced jurisprudence—by the simple expedient of deferring to a court of a sister state (never mind that it was not the state of incorporation!).

Part I of this Essay briefly describes the final days of Bear Stearns and the two deals it struck with J.P. Morgan. Part II provides a legal analysis of the

⁹ BUDGET DEV., PLANNING & ADMIN., OFFICE OF MGMT. & BUDGET, FINANCIAL SUMMARY: BUDGET DOLLAR GOVERNOR'S RECOMMENDED BUDGET: FISCAL YEAR 2008 (2006), available at <http://budget.delaware.gov/fy2008/operating/08opfinsumcharts.pdf> (forecasting revenues for 2008).

¹⁰ See *id.*

¹¹ Daines, *supra* note 1, at 1572.

¹² *Id.* at 1600.

¹³ Kahan & Rock, *supra* note 4, at 1588–89.

deal protection measures in the Bear Stearns–J.P. Morgan merger agreement, with particular attention to the Share Exchange Agreement (SEA), and explains why the SEA was probably invalid under current Delaware doctrine. Part III discusses the dilemma Delaware faced when asked to adjudicate a transaction that, on the one hand, was arguably needed to prevent the collapse of the financial system but that, on the other hand, was hard to reconcile with existing Delaware law. Delaware escaped this dilemma by staying the Delaware action in favor of a contemporaneous action filed in New York state court. Delaware’s decision to stay the action did not accord with its usual practice in resolving stay motions in significant corporate law cases and is best understood as a strategic decision to abstain from adjudicating a case that potentially threatened Delaware’s place in the corporate lawmaking landscape. Part IV examines the implications for corporate federalism.

I. BACKGROUND

The spectacular failure of Bear Stearns was front-page news. Now that the dust has settled, the outlines of what happened are reasonably clear, although there is much that remains mysterious. What follows is a sketch of the chain of events that led to J.P. Morgan’s acquisition of Bear Stearns.¹⁴

During the week of March 10, 2008, rumors began to circulate on Wall Street that Bear Stearns was in trouble, and customers began leaving in droves.¹⁵ By the end of the day on Thursday, March 13, it was clear that Bear Stearns faced a crisis.¹⁶ So many customers had removed their assets that Bear Stearns had exhausted \$15 billion in cash reserves.¹⁷ Lenders who financed Bear Stearns’s operations refused to replenish the financing.¹⁸ Clients of other banks were pushing to get out of trades with Bear Stearns.¹⁹ By the evening of March 13, Bear Stearns was considering all options: it turned to J.P. Morgan to

¹⁴ See generally Bryan Burrough, *The Collapse: Bringing Down Bear Stearns*, VANITY FAIR, Aug. 2008, at 106; Kate Kelly, *Bear Stearns Neared Collapse Twice in Frenzied Last Days: Paulson Pushed Low-Ball Bid, Relented; a Testy Time for Dimon*, WALL ST. J., May 29, 2008, at A1 [hereinafter Kelly, *Neared Collapse*]; Kate Kelly, *Lost Opportunities Haunt Final Days of Bear Stearns: Executives Bickered over Raising Cash, Cutting Mortgages*, WALL ST. J., May 27, 2008, at A1 [hereinafter Kelly, *Lost Opportunities*]; Kate Kelly, *Fear, Rumors Touched Off Fatal Run on Bear Stearns*, WALL ST. J., May 28, 2008, at A1 [hereinafter Kelly, *Fear*].

¹⁵ Burrough, *supra* note 14, at 108; Kelly, *Fear*, *supra* note 14.

¹⁶ Kelly, *Fear*, *supra* note 14.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

see if J.P. Morgan would buy it; it considered filing for bankruptcy; and it spoke constantly with representatives of the Federal Reserve Bank of New York camped out in its offices.²⁰

By early morning on Friday, March 14, time had run out. The Federal Reserve and the Department of the Treasury (Treasury) were concerned that a Bear Stearns collapse would have far-reaching effects.²¹ A Federal Reserve official was quoted as saying: “For the first time in history the entire world was looking at the failure of a major financial institution that could lead to a run on the entire world financial system It was clear we couldn’t let that happen.”²² To prevent this from happening, J.P. Morgan, with nonrecourse financing from the Federal Reserve, agreed to provide financing to Bear Stearns for “up to 28 days.”²³

With the J.P. Morgan and Federal Reserve commitments, Bear Stearns was able to open for business on Friday, but customers continued to flee and trading partners continued to disappear.²⁴ Throughout the day, Bear Stearns’s stock price continued to drop, closing at \$32 per share.²⁵ Teams from J.P. Morgan, private equity firms J.C. Flowers (Flowers) and Kohlberg Kravis Roberts & Co., and major banks poured over Bear Stearns’s financials.²⁶ Friday evening, Treasury Secretary Henry Paulson and Federal Reserve Bank of New York President Timothy Geithner made it clear that a deal to sell Bear Stearns had to be announced by early Sunday evening when the Asian markets opened.²⁷ The twenty-eight-day window had suddenly closed.

By the end of the day on Saturday, March 15, Flowers made an offer contingent on lining up financing to continue Bear Stearns’s operations.²⁸ Later, J.P. Morgan indicated that it might be willing to buy Bear Stearns for \$8 to \$12 per share.²⁹

²⁰ Burrough, *supra* note 14, at 152–53; Kelly, *Fear*, *supra* note 14.

²¹ Burrough, *supra* note 14, at 153.

²² *Id.* at 154.

²³ Kelly, *Fear*, *supra* note 14.

²⁴ Burrough, *supra* note 14, at 154.

²⁵ *Id.*

²⁶ Kelly, *Neared Collapse*, *supra* note 14.

²⁷ Burrough, *supra* note 14, at 154; Kelly, *Neared Collapse*, *supra* note 14.

²⁸ Kelly, *Neared Collapse*, *supra* note 14.

²⁹ *Id.*

On Sunday morning, J.P. Morgan presented a draft merger agreement with the price left blank.³⁰ It became clear that Flowers would not be able to go forward. At about 10 a.m., J.P. Morgan withdrew its offer, but soon returned with a \$4 per share offer, with the Federal Reserve taking responsibility for \$30 billion of illiquid securities.³¹ Bear Stearns's managers, irate with the low \$4 per share price, seriously contemplated filing for bankruptcy.³² Paulson spoke with J.P. Morgan CEO Jamie Dimon and pushed for a price even lower than \$4 per share.³³ Paulson wanted to avoid the impression that the government was bailing out the shareholders of an investment bank that had engaged in speculation, while offering no help to the little guy who had defaulted on his sub-prime mortgage.³⁴

By mid-afternoon on Sunday, March 16, J.P. Morgan made a firm offer of \$2 per share.³⁵ Faced with a choice of filing for bankruptcy or accepting \$2 per share, the Bear Stearns board accepted.³⁶

The March 16 merger agreement contained a variety of fairly standard "deal protection" measures. J.P. Morgan received an option to buy Bear Stearns's corporate headquarters building for \$1.1 billion (Asset Option), and an option to buy just under 20% of Bear Stearns stock at \$2 per share.³⁷ The Bear Stearns board also provided the necessary approvals to waive the limitations on business combinations under § 203 of Delaware General Corporation Law (DGCL).³⁸ But, as is the case with most mergers, under § 251 of the DGCL, the Bear Stearns–J.P. Morgan merger required approval by a majority of Bear Stearns's outstanding shares.³⁹

During the week of March 17, it became clear that Bear Stearns shareholder approval could not be assumed. A variety of shareholders,

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ Heidi N. Moore, *Bear Stearns: How to Buy a Distressed Investment Bank*, WALL ST. J., May 28, 2008, at A1.

³⁸ AGREEMENT & PLAN OF MERGER BY & BETWEEN THE BEAR STEARNS COMPANIES, INC. & JPMORGAN CHASE & CO., § 3.10, at 14 (Mar. 16, 2008), available at http://www.bearstearns.com/includes/pdfs/investor_relations/merger.pdf; see DEL. CODE ANN. tit. 8, § 203 (2007) (detailing three-year limitation on business combinations between corporations and interested stockholders unless certain conditions are met).

³⁹ See DEL. CODE ANN. tit. 8, § 251(c).

including some of the largest ones, had seen the value of their Bear Stearns shares fall from a high of \$131.58 in October 2007 to \$70 per share in early March 2008, and now voiced opposition to the proposed merger at \$2 per share.⁴⁰ Many took the position that if that was all they would get, they might as well take their chances.⁴¹ Approval of the merger on the original terms seemed far from certain.⁴² At the same time, customers continued to pull out assets, thus reducing the value of the company as a stand-alone entity or as an acquisition target.

In response to shareholder opposition, Bear Stearns and J.P. Morgan revisited the original \$2 deal. J.P. Morgan demanded, as part of any renegotiated deal, that Bear Stearns allow it to hold 51% of Bear Stearns shares to assure shareholder approval.⁴³ Bear Stearns argued that it would need to get a higher price per share.⁴⁴ Over the weekend of March 22–23, intense negotiations continued. Concerned again that a Bear Stearns bankruptcy could imperil the financial system, Paulson reluctantly acquiesced in a higher price.⁴⁵ In the early morning hours of March 24, a revised deal was announced.⁴⁶ Under the Amended Merger Agreement and the related SEA, the merger consideration was increased to about \$10 per share, the J.P. Morgan and Federal Reserve guarantees were limited, the § 203 waiver and the Asset Option were retained, and, most importantly for our purposes, an additional deal protection measure was included: the share exchange.⁴⁷ Under the SEA, J.P. Morgan would receive, through an exchange of J.P. Morgan shares, 95 million newly issued shares of Bear Stearns common stock (amounting to 39.5% of the then-outstanding shares), with the share exchange to be completed before the April 8, 2008 record date for the Bear Stearns shareholder vote on the Amended Merger Agreement.⁴⁸ The admitted purpose

⁴⁰ Kelly, *Fear*, *supra* note 14.

⁴¹ Kelly, *Neared Collapse*, *supra* note 14.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *In re Bear Stearns Cos., Inc. S'holder Litig.*, No. 3643-VCP, 2008 Del. Ch. LEXIS 46, at *8–*9 (Del. Ch. Apr. 9, 2008).

⁴⁸ J.P. Morgan Co., Inc., Current Report (Form 8-K), at 2 (Mar. 24, 2008), available at <http://www.secinfo.com/drDX9.t9g.htm#1stPage>.

of the SEA was to provide assurance to J.P. Morgan that the transaction would receive the requisite approval of Bear Stearns shareholders.⁴⁹

Neither the Amended Merger Agreement nor the SEA limited J.P. Morgan's ability to acquire additional shares. Without limits placed on market purchases, J.P. Morgan bought an additional 11.5 million shares at \$12.23 per share on March 24, the date the SEA was announced,⁵⁰ and another 10 million shares or so before April 18.⁵¹ According to J.P. Morgan's own securities filings, these purchases were made to "increase the likelihood that the plan to rescue Bear Stearns [would] be completed."⁵² By the time of the Bear Stearns shareholder vote, J.P. Morgan controlled around 49.73% of all outstanding shares.⁵³ And it had acquired this stake without any approval of the other Bear Stearns shareholders.

The frenzied negotiations were, of course, accompanied by the filing of lawsuits. On March 17 and 18, the two days following the \$2-per-share merger agreement announcement, stockholder class actions were filed in New York Supreme Court.⁵⁴ On Thursday, March 20, and Monday, March 24 (the day the Amended Merger Agreement and SEA were announced), stockholder class actions were filed in Delaware Chancery Court.⁵⁵ On March 27, the defendants moved to dismiss or stay the Delaware action in favor of the New York action. On April 9, the Delaware Chancery Court granted the motion to

⁴⁹ JPMorgan Chase & Co. et al., General Statement of Beneficial Ownership (Form 13D), at 6 (Apr. 3, 2008) [hereinafter JPMorgan, April 3 13D], available at <http://www.secinfo.com/d14D5a.t28H1.htm#1stPage> ("J.P. Morgan Chase acquired the shares of Common Stock in order to increase the likelihood that the plan to rescue Bear Stearns will be completed.").

⁵⁰ *Id.* at 16.

⁵¹ See JPMorgan Chase & Co. et al., Amendment to General Statement of Beneficial Ownership (Form 13D/A), at 6 (Apr. 21, 2008) [hereinafter JPMorgan, April 21 13D], available at <http://www.secinfo.com/drDX9.tEk.htm#1stPage> (stating that J.P. Morgan purchased approximately 200,000 shares between April 15, 2008, and April 18, 2008); JPMorgan Chase & Co. et al., Amendment to General Statement of Beneficial Ownership (Form 13D/A), at 6 (Apr. 15, 2008), available at <http://www.secinfo.com/drDX9.tdr.htm#1stPage> (stating that J.P. Morgan purchased approximately 3.3 million shares between April 11, 2008, and April 14, 2008); JPMorgan Chase & Co., Amendment to General Statement of Beneficial Ownership (Form 13D/A), at 6 (Apr. 11, 2008), available at <http://www.secinfo.com/drDX9.tCy.htm#1stPage> (stating that J.P. Morgan purchased approximately 2.4 million shares between April 8, 2008, and April 10, 2008); JPMorgan Chase & Co. et al., Amendment to General Statement of Beneficial Ownership (Form 13D/A), at 6 (Apr. 8, 2008), available at <http://www.secinfo.com/d14D5a.t2bFc.htm#1stPage> (stating that J.P. Morgan purchased approximately 3.2 million shares between March 25, 2008, and April 7, 2008).

⁵² JPMorgan, April 3 13D, *supra* note 49, at 6.

⁵³ JPMorgan, April 21 13D, *supra* note 51, at 6.

⁵⁴ *In re Bear Stearns Cos., Inc. S'holder Litig.*, No. 3643-VCP, 2008 Del. Ch. LEXIS 46, at *9 (Del. Ch. Apr. 9, 2008).

⁵⁵ *Id.*

stay.⁵⁶ Thus, it looked like it would be the New York court, rather than the Delaware court, that would decide the issues raised by the case and, specifically, the important question of whether the Bear Stearns board acted appropriately in signing the SEA.

The end of this story, alas, is anticlimactic. With no other bid forthcoming and shareholder opposition waning, on May 7 the plaintiffs in the New York action withdrew their motion to enjoin the merger.⁵⁷ On May 29, the merger was approved by 84% of the Bear Stearns shares.⁵⁸ On December 4, the New York damages action was dismissed on summary judgment.⁵⁹

II. THE ISSUES UNDER DELAWARE LAW

The SEA, under which J.P. Morgan acquired 39.5% of the Bear Stearns shares in advance of the shareholder vote, was an unprecedented deal protection measure and raised difficult and important issues under Delaware law.⁶⁰ In this Part, we argue that, under *existing* statutory and case law, the SEA was invalid and should have been enjoined. This, of course, does not mean that we believe that a Delaware court actually would have invalidated the SEA. To the contrary, as we discuss below, we think that the SEA would have been upheld by any court asked to rule on it. It was this combination—the practical necessity of upholding the SEA versus its dubious legality under current Delaware law—that put the SEA challenge into the “Hard Cases Make Bad Law” category and placed Delaware in a peculiar dilemma.

Mergers under DGCL § 251 require both a recommendation of the board of directors and approval by a majority of the outstanding shares.⁶¹ This

⁵⁶ *Id.* at *8.

⁵⁷ JPMorgan Chase & Co., Quarterly Report (Form 10-Q), at 116 (May 12, 2008), available at <http://www.secinfo.com/dsvr4.t5Cs.htm#1stPage>.

⁵⁸ Kate Kelly, Mike Spector, & Randall Smith, *The Fall of Bear Stearns: Bear's Final Moment: An Apology and No Lack of Ire*, WALL ST. J., May 30, 2008, at C1.

⁵⁹ *In re Bear Stearns Litig.*, 2008 N.Y. Misc. LEXIS 7075 (N.Y. Sup. Ct. Dec. 4, 2008).

⁶⁰ Although, under New York Stock Exchange (NYSE) rules, shareholder approval is ordinarily required for issuance of more than 20% of outstanding shares, *see* NYSE, Inc., Listed Company Manual § 312.03 (2007), an exception can be granted by the NYSE “when (1) the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise and (2) reliance by the company on this exception is expressly approved by the Audit Committee of the Board,” *see id.* § 312.05. In entering into the SEA, Bear Stearns relied on this exception and, on April 4, received approval from the NYSE. Press Release, Bear Stearns Cos. Inc., Bear Stearns Receives NYSE Approval for Shares to Be Issued to J.P. Morgan Chase (Apr. 4, 2008), <http://www.reuters.com/article/pressRelease/idUS208849+04-Apr-2008+BW20080404>.

⁶¹ DEL. CODE ANN. tit. 8, § 251 (2007).

two-stage process is a centerpiece of the Delaware corporate governance system, with both elements considered critical. The Delaware Supreme Court has held that a board cannot submit a merger agreement to the shareholders without making a recommendation, and the board's duty to take a position on a merger is one of the hooks on which the structure of fiduciary duties is hung.⁶² Equally, the shareholders' right under § 251(a) to vote down a merger approved by the board forms the foundation of courts' scrutiny of defensive tactics, including deal protection measures.⁶³ Although issues arise in a variety of contexts, the fundamental principle governing these issues is that shareholders' votes must be uncoerced.⁶⁴

In a recent law review article, Delaware Court of Chancery Vice Chancellor Leo Strine argued that a focus on "uncoerced stockholder choice" provided the best guide to the case law that balances the competing interests.⁶⁵ Although, said Strine, this standard provides substantial discretion to directors, it also sets clear limits:

At the same time, this emphasis on stockholder choice recognizes that a stock-for-stock merger agreement is not an ordinary contract within the sole power of the directors to consummate. Stockholders have the right to vote yes or no without being, in essence, compelled or coerced. Stockholders can legitimately expect that their directors will bring a merger proposal to a reasonably prompt vote so that the mere passage of time does not leave the board's preferred deal as the only viable corporate strategy. Stockholders also have a right to a genuine, current recommendation from their directors regarding the advisability of the transaction.⁶⁶

The fundamental problem with the Bear Stearns–J.P. Morgan SEA is that it eliminated the effective "right to vote yes or no without being . . . compelled or coerced."⁶⁷ In doing so, it made a mockery of the approval requirement under § 251.

⁶² Smith v. Van Gorkom, 488 A.2d 858, 879 (Del. 1985); see also A. Gilchrist Sparks, III, *Merger Agreements Under Delaware Law—When Can Directors Change Their Minds?*, 51 U. MIAMI L. REV. 815, 818–19 (1997).

⁶³ See, e.g., *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42–43 (Del. 1994).

⁶⁴ See, e.g., *id.*

⁶⁵ Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919, 941–42 (2001).

⁶⁶ *Id.* at 942.

⁶⁷ *Id.*

In this Part, we first discuss three separate doctrinal frameworks in Delaware law through which a Delaware court would likely have analyzed the Bear Stearns–J.P. Morgan SEA: the *Unocal/Unitrin* framework, the *Omnicare* framework, and the *Condec/Blasius* framework.⁶⁸ We then discuss some arguments, based on existing precedent, for upholding the agreement. We conclude that, under existing doctrine, the case for upholding the SEA was weak. This placed a Delaware court in a very difficult situation. A Delaware judge could have done one of the following if forced to make a decision: invalidate the agreement, with the risks that entailed; fashion a new rule of Delaware law that Delaware would then have to spend years explaining and limiting; or pretend, under the world’s attention, that the facts of the case or the law of Delaware were different from what they were, and thus expose the court to ridicule. None of these was an attractive option.

A. *The Unocal/Unitrin Analysis*

The *Unocal Corp. v. Mesa Petroleum Co.*⁶⁹ and *Unitrin, Inc. v. American General Corp.*⁷⁰ cases provide the basic framework within which Delaware courts review defensive actions by a board of directors. As the earlier description makes clear, the SEA was adopted to ensure that the preferred deal

⁶⁸ The Bear Stearns–J.P. Morgan SEA also raised issues under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985). Whether or not the Bear Stearns–J.P. Morgan merger was approved, the SEA combined with J.P. Morgan’s freedom to acquire additional shares created a controlling shareholder where there had not been one before. See *supra* notes 50–53 and accompanying text. Therefore, under *QVC* the SEA could trigger *Revlon* (although, because J.P. Morgan itself is widely held, one could argue that it does not). See *QVC*, 637 A.2d at 46 (stating that a stock-for-stock merger that results in a controlling shareholder in a company that previously had dispersed ownership constitutes a change of control that triggers *Revlon* duties). However, it is not clear that an analysis under *Revlon* adds anything to the analyses under *Unocal/Unitrin*, *Omnicare*, and *Condec/Blasius*. See *infra* Part III.A–C. It could be important in two different ways. First, when a board is in “*Revlon mode*,” only shareholder interests count. *QVC*, 637 A.2d at 44 (“In the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders—and they must exercise their fiduciary duties to further that end. The decisions of this Court have consistently emphasized this goal.”). Second, *Revlon* requires some sort of market test: either an auction before an agreement is reached or at least the possibility of a competing bid afterward. *Id.* at 44–45. Because of time pressures, only the briefest of auctions was conducted before the merger agreement was signed. See *supra* notes 29–36 and accompanying text. The SEA, combined with J.P. Morgan’s post-March 24 stock purchases, gave J.P. Morgan a 49.7% position and, in so doing, precluded any sort of post-agreement market test. See *supra* notes 50–53 and accompanying text. Whether, in this circumstance, the board could, consistent with *Revlon*, agree to a deal that did not leave the shareholders with the opportunity to accept a competing bid is an issue fully discussed in the context of *Omnicare v. NCS Healthcare Inc.*, 818 A.2d 914 (Del. 2003). See *infra* Part III.B.

⁶⁹ 493 A.2d 946, 958 (Del. 1985).

⁷⁰ 651 A.2d 1361, 1367 (Del. 1995).

with J.P. Morgan was approved and that no competing bid emerged.⁷¹ It was, therefore, a classic defensive measure subject to the two-pronged *Unocal/Unitrin* test. The first prong requires that the board reasonably perceives that there is a threat to the corporation.⁷² The second prong requires that any defense be reasonable in relation to the threat.⁷³

The second prong of the *Unocal/Unitrin* test is of particular interest here. *Unitrin* established a bifurcated analysis for deciding whether a defense is reasonable.⁷⁴ First, the court must decide whether a defense is coercive or preclusive.⁷⁵ If the court finds a defense to be coercive or preclusive, it will find that defense invalid.⁷⁶ Second, if a defense is not, the court then turns to whether the defense falls within a “range of reasonableness,” a relatively permissive standard.⁷⁷ *Unitrin* provided definitions of both key concepts: a response is “coercive” if it is aimed at forcing on stockholders a management-sponsored alternative to a hostile offer;⁷⁸ and 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.⁷⁹

Applying *Unitrin*’s definitions directly, it is difficult to imagine an action by a board that could be more coercive and preclusive than the SEA. With the SEA, J.P. Morgan instantly acquired a 39.5% voting block, almost 80% of the votes needed to approve the merger. But the SEA did not stop there. It did not contain any standstill agreement or other limitation on J.P. Morgan’s market purchases, any duty by J.P. Morgan to support a higher offer, or any right of the board not to submit the merger to a shareholder vote if it no longer recommended the merger.⁸⁰ In fact, J.P. Morgan, unconstrained by any such restrictions, immediately began acquiring additional Bear Stearns shares so

⁷¹ See *supra* notes 43–48 and accompanying text.

⁷² *Unocal*, 493 A.2d at 958.

⁷³ *Unitrin*, 651 A.2d at 1367.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.* at 1387–88.

⁷⁸ *Id.* at 1387 (citing *Paramount Commc’ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1154–55 (Del. 1989)).

⁷⁹ See *id.* (citing *Paramount*, 571 A.2d at 1154–55) (stating that because Time’s board did not preclude Paramount from making an offer for the combined Time-Warner company, the board’s response was not preclusive).

⁸⁰ Bear Stearns Cos., Inc., Current Report: Share Exchange Agreement (Form 8-K, Exh. 2.2), at § 2.2 (Mar. 24, 2008) [hereinafter March 24 Exhibit], available at <http://www.secinfo.com/dRSm6.t8b.c.htm#1stPage>.

that it had just shy of 50% of the outstanding shares in advance of the meeting to vote on the merger.⁸¹ Of course, J.P. Morgan could have easily acquired a little more, giving it the power to approve the merger without the vote of a single other shareholder,⁸² but what would have been the point of doing so?

Under these circumstances, two things were clear: existing shareholders could not vote the deal down and remain independent, and no other bidder would have had any chance of succeeding with a higher offer. Thus, the SEA was coercive under the *Unitrin* definition because it literally forced the Bear Stearns–J.P. Morgan merger on shareholders. Even if an overwhelming majority of the non-J.P. Morgan shareholders would have opposed the merger, the merger would still have received the requisite shareholder votes. The SEA was preclusive because it deprived shareholders of the ability to receive any other offers and precluded any other bidder from seeking control, by giving the board's preferred merger partner a controlling interest, the most fundamental restriction possible of a proxy contest.

Notably, the Bear Stearns board entered into the SEA without any shareholder approval and, as far as we know, without even consulting any of the larger Bear Stearns shareholders not represented on the Bear Stearns board. Indeed, the SEA and the Amended Merger Agreement were motivated by shareholder opposition to the initial deal struck by the board.⁸³ With shareholders up in arms and threatening to oppose the initial merger, the board, on its own, gave up the effective right of shareholders to vote down the J.P. Morgan deal in exchange for an increase in the merger consideration. To be sure, the increase (relative to the original \$2 deal) was substantial. But the obvious point of the dual approval requirement embodied in § 251 is not that the board can dispense with a shareholder vote if a deal is good enough, but that it is the prerogative of the *shareholders* to decide, in an uncoerced fashion, *whether* a deal is good enough.⁸⁴ Undermining this principle would have important ramifications for Delaware law.

Indeed, there is a large Delaware jurisprudence on the permissible scope of deal protection measures under *Unocal/Unitrin*. The issue typically arises in contexts very similar to the Bear Stearns–J.P. Morgan situation: a target board and an acquirer, which have negotiated a merger agreement, are concerned that

⁸¹ JPMorgan, April 3 13D, *supra* note 49.

⁸² March 24 Exhibit, *supra* note 80, at § 2.2.

⁸³ Kelly, *Neared Collapse*, *supra* note 14.

⁸⁴ *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42–43 (Del. 1994).

shareholders will not approve it. To address this possibility, the merger agreement sometimes includes a variety of measures, such as an agreement to sell a valuable asset for a low price (asset lockup), an agreement to sell a block of shares for either a low price or the deal price (stock lockup), or an agreement to pay the merger party a sum of money (termination fee), each contingent on the deal not being approved.⁸⁵

The traditional deal protection measures discussed in Delaware cases are significantly less coercive and preclusive than the provisions at issue in the Bear Stearns–J.P. Morgan merger. Typical provisions such as asset and stock lockups and termination fees are primarily designed to confer an *economic* benefit on the favored bidder if another bidder should acquire the target at a higher price (or, to a lesser extent, if shareholders independently fail to approve the deal).⁸⁶ Their direct effect is thus to offer a consolation prize to the favored bidder should the deal fall through, as compensation and inducement for the effort to make a bid to start with. Despite their names, lockup provisions do not confer nearly enough (and often no) voting power on the favored bidder to *lock up* a deal in the literal sense.⁸⁷ Any lockup effect of these traditional measures is generated by the size of the economic benefit conferred on the friendly acquirer.⁸⁸ Because this benefit comes out of the pocket of target shareholders (and, if there is hostile interference, of the hostile bidder),⁸⁹ any alternative to the negotiated merger must be sufficiently valuable to the target shareholders to make it economically desirable for them to reject the merger. This, of course, depends on the value of the negotiated merger to target shareholders, the size of the economic benefit conferred by the deal protection devices, and the value of any alternative—factors that will differ from case to case.⁹⁰ Some commentators believe that these traditional devices rarely affect the outcome of a bidding contest.⁹¹ Still, at least in theory, these

⁸⁵ These deal protection devices, if large enough, also have the effect of discouraging competing bids. We do not address this aspect directly as there was no competing offer for Bear Stearns and no evidence that a competing offer was scared away by the deal protection measures.

⁸⁶ Marcel Kahan & Michael Klausner, *Lockups and the Market for Corporate Control*, 48 STAN. L. REV. 1539, 1545 (1996).

⁸⁷ *Id.* at 1543.

⁸⁸ *Id.* at 1545.

⁸⁹ *Id.* at 1542, 1545.

⁹⁰ See Ian Ayres, *Analyzing Stock Lock-Ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 COLUM. L. REV. 682, 704 (1990); Kahan & Klausner, *supra* note 86.

⁹¹ See Ayres, *supra* note 90, at 703–04 (arguing that only “foreclosing” lockups affect the outcome of a contest); Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739 (1994).

traditional sorts of deal protection measures can rise to a magnitude at which they economically coerce shareholders into approving a merger.

Vice Chancellor Strine provided the following intentionally extreme example of an unacceptable measure:

In our hypothetical merger agreement, for example, provided that Angstrom would receive a 50% termination fee if the Zuckerman stockholders voted no, very few of us would think that was permissible. By making the costs of voting no[t] so extreme, the Zuckerman board has in effect usurped all of the power to approve the merger to itself, in derogation of the statutory allocation of powers. Put simply, the Zuckerman board cannot contract away its stockholders' right to make an uncoerced decision.⁹²

Delaware courts have enjoined traditional deal protection measures which interfere with shareholders' decisions. Thus, for example, in *Paramount Communications, Inc. v. QVC Network, Inc.*,⁹³ the Delaware Supreme Court addressed the combination of a \$100 million termination fee and an uncapped option to purchase 19.9% of the stock at the deal price with unusually favorable payment terms (payable with a note, with a right to settle in cash).⁹⁴ Both the termination fee and the stock option would have been triggered by a negative shareholder vote.⁹⁵ The court held that the stock option contained several "draconian" features and was clearly invalid.⁹⁶ In other cases, Delaware courts have approved termination fees in the range of 2% to 4% of a deal's value,⁹⁷ have expressed skepticism about a fee over 6%,⁹⁸ and have made it clear that there are no hard and fast rules.⁹⁹

The SEA is substantially more draconian than these deal protection devices. From a purely economic perspective, should there be a bidding war

⁹² Strine, *supra* note 65, at 933 n.39.

⁹³ 637 A.2d 34 (Del. 1994).

⁹⁴ *Id.* at 39.

⁹⁵ *Id.*

⁹⁶ *Id.* at 50.

⁹⁷ See *In re Pennaco Energy, Inc.*, 787 A.2d 691, 707 (Del. Ch. 2001) (3%); *McMillan v. Intercargo Corp.*, 768 A.2d 492, 505–06 (Del. Ch. 2000) (3.5%); *Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 49 (Del. 1996) (2%); *Kysor Indus. Corp. v. Margaux, Inc.*, 674 A.2d 889, 897 (Del. Super. Ct. 1996) (2.8%); *Roberts v. Gen. Instrument Corp.*, No. 11639, 1990 WL 118356, at *9 (Del. Ch. Aug. 13, 1990) (2%); *Lewis v. Leaseway Transp. Corp.*, No. 8720, 1990 WL 67383, at *3, *8 (Del. Ch. May 6, 1990) (3%); *Braunschweiger v. Am. Home Shield Corp.*, No. 10755, 1989 WL 128571, at *4, *7 (Del. Ch. Oct. 26, 1989) (2.3%).

⁹⁸ *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, Nos. 17398, 17383, & 17427, 1999 WL 1054255, at *2 (Del. Ch. Sept. 27, 1999).

⁹⁹ *L.A. Mun. Police Employees' Ret. Sys. v. Crawford*, 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007).

for Bear Stearns, the 39.5% SEA would offer an even greater opportunity for profits than the uncapped 19.9% stock option that was held invalid in *QVC*.¹⁰⁰ More importantly, however, the SEA, whether considered by itself or in the context of J.P. Morgan's permitted additional stock purchases, conferred on J.P. Morgan sufficient voting power to make it virtually impossible for existing Bear Stearns shareholders to vote down the Amended Merger Agreement.

From this perspective, the facts of *Unitrin* are illustrative. In *Unitrin*, the board of Unitrin was faced with a hostile offer and engaged in a share repurchase that increased the stake held by board members (who had agreed not to sell their shares) from 23% to 28%.¹⁰¹ The Chancery Court invalidated the share repurchase program under *Unocal*.¹⁰² The Delaware Supreme Court reversed, finding that the program was neither coercive nor preclusive.¹⁰³ But in doing so, it engaged in a probing analysis of Unitrin's shareholder base. First, it found that there was no reason to believe that all board members—which included some large, outside shareholders—would automatically oppose any bid.¹⁰⁴ Moreover, even if all board members opposed the bid, the court found that the increase in the board's stake from 23% to 28%, given the percentage of shares held by institutional investors, would not present a barrier that a hostile bidder could not realistically overcome.¹⁰⁵

The contrast between the facts in *Unitrin* and those in the Bear Stearns situation are stark. Unlike the outside board members in *Unitrin*, J.P. Morgan could surely be expected to oppose any competing bid and to vote in favor of the merger even if, at the time of the vote, the merger looked like a bad deal for Bear Stearns. The SEA represented an *increase* in J.P. Morgan's ownership

¹⁰⁰ The distinction between the actual acquisition of stock envisioned by the SEA and the mere option in *QVC* is not economically meaningful in the context of these transactions. To be sure, the fact that Viacom only received an option means that it would have had no incentive to exercise the option if the value of Paramount dropped below the deal price. *QVC*, 637 A.2d at 39. But Viacom also had a contractual obligation to consummate the merger at the deal price. *Id.* If the value of Paramount dropped, it was Viacom's contractual obligation under the merger agreement that is important and not Viacom's rights under the deal protection measures. But if Viacom had consummated the merger, it would not have mattered whether it first exercised the option. Because Viacom had an obligation to consummate the merger under the merger agreement, the fact that Viacom received an option rather than shares conferred no downside risk protection on Viacom.

¹⁰¹ *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1377–78 (Del. 1995).

¹⁰² *Id.* at 1375–77.

¹⁰³ *Id.* at 1388.

¹⁰⁴ *Id.* at 1380–81.

¹⁰⁵ *Id.* at 1383.

that, on its own, was *eight* times higher than the increase at issue in *Unitrin*—from 0% to 39.5%¹⁰⁶ versus 23% to 28%.¹⁰⁷ Adding the 11.5 million shares that J.P. Morgan acquired contemporaneously with the announcement of the SEA brought J.P. Morgan's stake to 45%; including the shares acquired in the ensuing weeks, J.P. Morgan's ownership increased to 49.73%.¹⁰⁸ Any notion that the deal was not locked up by March 24—because J.P. Morgan's ownership was below 50% and there was a hypothetical possibility that the shareholders would not approve the deal¹⁰⁹—flies in the face of both reality as well as the careful, contextual analysis performed by the Delaware Supreme Court in *Unitrin*.

For these reasons, we believe that the SEA was coercive and preclusive and therefore invalid under *Unocal/Unitrin*. But even if the SEA could somehow survive *Unocal/Unitrin* scrutiny, it would face further hurdles.

B. The Omnicare Analysis

The 2003 Delaware Supreme Court opinion in *Omnicare v. NCS Healthcare, Inc.* arose in the specific context of voting agreements and has particular application to the SEA.¹¹⁰ At issue in *Omnicare* were agreements by the controlling shareholders to vote in favor of a proposed merger and an agreement by the board to submit the merger to a shareholder vote even if it no longer believed, at the time of the vote, that the merger was in the company's best interest.¹¹¹ The Delaware Supreme Court held that these agreements were coercive and preclusive because they rendered the merger a *fait accompli*:

The record reflects that the defensive devices employed by the NCS board are preclusive and coercive in the sense that they accomplished a *fait accompli*. In this case, despite the fact that the NCS board has withdrawn its recommendation for the Genesis transaction and recommended its rejection by the stockholders, the deal protection devices approved by the NCS board operated in concert to have a preclusive and coercive effect.¹¹²

¹⁰⁶ JPMorgan, April 3 13D, *supra* note 49, at 8.

¹⁰⁷ *Unitrin*, 651 A.2d at 1377–78.

¹⁰⁸ JPMorgan, April 3 13D, *supra* note 49, at 8.

¹⁰⁹ See *supra* text accompanying notes 83–84.

¹¹⁰ 818 A.2d 914, 918 (Del. 2003).

¹¹¹ *Id.*

¹¹² *Id.* at 936.

Omnicare is a problematic and widely criticized opinion.¹¹³ The voting agreements in that case were executed by the company's *shareholders*, not by the board of directors.¹¹⁴ The agreements thus did not raise the concern underlying *Unocal* that the board was acting in its own interest in adopting a defensive device or the concern that *the board* was usurping shareholders' effective right to vote on a merger.¹¹⁵ To be sure, the board in *Omnicare* made a firm agreement to submit the merger to a shareholder vote.¹¹⁶ Such agreements, however, are specifically permitted by the DGCL,¹¹⁷ and the court did not find any flaws in the process that the board engaged in before it signed the agreement.¹¹⁸ Rather, the holding in *Omnicare* was based on the principle that there must always be an effective "out," and if the shareholder vote is not an effective out (because of voting agreements signed by the shareholders) then the board cannot give up the right to withdraw its recommendation and pull the proposed deal from a shareholder vote.¹¹⁹

Under the reasoning of *Omnicare*, the SEA would face an uphill battle. As in *Omnicare*, the Bear Stearns board agreed to submit the merger to a shareholder vote even if it no longer believed, at the time of the vote, that the merger was in the company's best interest. The SEA, in effect, accomplished a *fait accompli*. Even standing by itself, the 39.5% stake transferred in the SEA would make it exceedingly difficult to defeat the deal on the shareholder level. But coupled with J.P. Morgan's contemporaneous acquisition of another 5% of Bear Stearns's stock, and its further acquisition of another 5% over the following weeks, this extreme difficulty became an impossibility. Given the timing of these acquisitions and the lack of any contractual restrictions on J.P.

¹¹³ E.g., Wayne O. Hanewicz, *Director Primacy, Omnicare, and the Function of Corporate Law*, 71 TENN. L. REV. 511, 512–13 (2004); Robert A. Profusek & Lyle G. Ganske, *Lockups and Beyond in "Omnicare v. NCS Healthcare,"* N.Y.L.J., May 30, 2003, at 4. Although *Omnicare* has been criticized, and many Delaware practitioners expect that it will be overruled or limited when the issue is next taken up by the Delaware Supreme Court, there are no post-*Omnicare* Delaware Supreme Court opinions that cast any doubt on it.

¹¹⁴ *Omnicare*, 818 A.2d at 926.

¹¹⁵ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955–57 (Del. 1985). Although the noncontrolling shareholders in *Omnicare* lacked an effective right to defeat the merger, that was true regardless of the voting agreement. The effect of the voting agreement was to eliminate the ability of the *controlling* shareholders to defeat the merger. *Omnicare*, 818 A.2d at 919. As the controlling shareholders had agreed to the voting agreement, it is hard to see what was problematic about this.

¹¹⁶ *Omnicare*, 818 A.2d at 918. The board of Bear Stearns made a similar commitment. March 24 Exhibit, *supra* note 80, at § 2.6.

¹¹⁷ DEL. CODE ANN. tit. 8, § 251(b)(6) (2007).

¹¹⁸ *Omnicare*, 818 A.2d at 918.

¹¹⁹ *Id.* at 936–37.

Morgan's right to purchase additional shares, it is evident that J.P. Morgan intended to buy additional shares and that Bear Stearns should have expected J.P. Morgan to buy additional shares when it agreed to the SEA. A court would thus be hard-pressed to ignore these purchases in analyzing the SEA.

Moreover, the SEA is substantially more problematic than the agreements at issue in *Omnicare*. In *Omnicare*, the existing controlling shareholders, acting in good faith and ensuring that noncontrolling shareholders would receive equal consideration, committed to vote in favor of the merger.¹²⁰ By contrast, the SEA was an issuance of *new* shares *by board action*, which when combined with J.P. Morgan's market purchases created a new controlling shareholder and was designed to take the decision entirely out of the hands of shareholders.¹²¹

C. *Interfering with the Shareholders' Vote*

Two overlapping lines of Delaware cases address attempts by a board to interfere with the exercise of the shareholder franchise. The older line of cases—*Condec Corp. v. Lunkenheimer Co.*¹²² and cases following it—addresses targeted stock issuances and has consistently enjoined stock issuances made to entrench management, to dilute controlling shareholders, or to change the outcome of a shareholder vote. The second, somewhat newer, line of cases derives from *Blasius Industries, Inc. v. Atlas Corp.*¹²³ As we discuss in this section, the SEA was probably invalid under the *Condec* line of cases, while the analysis under *Blasius* is not fully resolved. On the one hand, this means that the Delaware courts would not have had to engage in doctrinal contortions to reject a *Blasius* claim. On the other hand, it means that the question of the SEA's validity under *Blasius* raised important and novel issues under Delaware law.

In *Condec*, Lunkenheimer's board had agreed to sell all its assets to U.S. Industries, subject to approval by two-thirds of the outstanding shares.¹²⁴ Condec, which sought to merge with Lunkenheimer, bought shares in the market and, pursuant to a tender offer, accumulated enough shares to block approval.¹²⁵ In response, Lunkenheimer agreed to issue enough shares to U.S.

¹²⁰ *Id.* at 925–26.

¹²¹ See *supra* text accompanying notes 50–53.

¹²² 230 A.2d 769 (Del. Ch. 1967).

¹²³ 564 A.2d 651 (Del. Ch. 1988).

¹²⁴ *Condec*, 230 A.2d at 774.

¹²⁵ *Id.* at 774–75.

Industries (in exchange for shares of U.S. Industries) to assure the requisite stockholder approval.¹²⁶ The court concluded that the primary purchase of the share issuance was “to prevent control of Lunkenheimer from passing to Condec and to cause such control to pass into the hands of U.S. Industries.”¹²⁷ In light of this finding, the court enjoined the stock issuance, holding that

[T]he transaction here attacked . . . was clearly unwarranted because it unjustifiably strikes at the very heart of corporate representation by causing a stockholder with an equitable right to a majority of corporate stock to have his right to a proportionate voice and influence in corporate affairs to be diminished by the simple act of an exchange of stock which brought no money into the Lunkenheimer treasury, was not connected with a stock option plan or other proper corporate purpose, and which was obviously designed for the primary purpose of reducing Condec’s stock holdings in Lunkenheimer below a majority.¹²⁸

A variety of other cases, including *Canadian Southern Oils v. Manabi Exploration Co.*¹²⁹ and *Packer v. Yampol*¹³⁰ take a similar approach.¹³¹

Condec is very similar to this case. In both cases, the purpose of the share exchange was to affect the outcome of a shareholder vote. In both cases, no new capital was brought into the firm. In both cases, it was not part of a long-term plan to acquire new operations or to pursue any other long-term corporate interest. On the other hand, unlike in *Condec*, J.P. Morgan and Bear Stearns faced only the possibility of opposition by dispersed shareholders, rather than the definite opposition of a single majority shareholder. This being said, it is likely that here, as in *Condec*, the primary purpose of the share issuance was to

¹²⁶ *Id.* at 775.

¹²⁷ *Id.*

¹²⁸ *Id.* at 777.

¹²⁹ 96 A.2d 810 (Del. Ch. 1953) (enjoining issuance of shares where the primary purpose was to deprive majority shareholder of voting control).

¹³⁰ No. 8432, 1986 Del. Ch. LEXIS 413 (Del. Ch. Apr. 18, 1986) (enjoining the issuance of two newly created series of preferred stock with super voting features that had conferred approximately 33% of the outstanding voting rights).

¹³¹ See also *WNH Investments v. Batzel*, No. 13931, 1995 Del. Ch. LEXIS 47 (Del. Ch. Apr. 28, 1995) (enjoining dilutive stock issuance for the purpose of defeating a challenge to the board’s control); *Phillips v. Insituform*, No. 9173, 1987 Del. Ch. LEXIS 474 (Del. Ch. Aug. 27, 1987) (“[I] conclude that no justification has been shown that would arguably make the extraordinary step of issuance of stock for the admitted purpose of impeding the exercise of stockholder rights reasonable in light of the corporate benefit, if any, sought to be obtained.”); cf. *Frantz Mfg. Co. v. EAC Indus.*, 501 A.2d 401 (Del. 1985) (enjoining the issuance of shares to an employee stock ownership plan to dilute the holdings of a control shareholder just after control had been acquired as invalid entrenchment).

reduce the stock holdings of the potential opponents to the merger to less than a majority. There is no obvious reason why Delaware law should be *less* protective of the ability of dispersed shareholders to vote down a transaction than it is of the ability of a single shareholder to do so.

To be sure, because Delaware corporate law does not provide for mandatory preemptive rights, Delaware courts will not enjoin an issuance of stock merely because it will dilute the interests of existing stockholders. In *Glazer v. Zapata Corp.*,¹³² for example, Chancellor Allen refused to enjoin the issuance of shares as part of a financing transaction even though that issuance diluted the insurgent shareholder's interest. The difference between cases like *Glazer*, on the one side, and *Condec*, *Canadian Southern Oils*, and *Packer*, on the other, is the purpose of the issuance and, aligning this line of cases with *Unocal/Unitrin*, whether there is a threat to the corporation.¹³³ As the Chancery Court held in *Stahl v. Apple Bancorp*, "the prospects of losing a validly conducted shareholder vote cannot . . . constitute a legitimate threat to a corporate interest."¹³⁴ When stock is issued for the primary purpose of affecting the outcome of a shareholder vote, Delaware cases indicate that it will ordinarily be found to be an abuse of power.¹³⁵

Nonetheless, and in keeping with Delaware's fact-specific and case-by-case style of adjudication, there is no per se prohibition against dilutive stock issuances, even when their primary purpose is to affect the outcome of a shareholder vote. Although the Delaware courts have not, as far as we can tell, ever approved a dilutive stock issuance close to the magnitude of the SEA, the cases have been careful to leave open the possibility that intentionally diluting even a controlling shareholder may be justified if the issuance is, in language echoing *Blasius*, "to further a compelling corporate purpose."¹³⁶ Thus, in

¹³² 658 A.2d 176 (Del. Ch. 1993).

¹³³ *Id.* at 186 ("These cases stand for the proposition that directors may not act to frustrate the efforts of stockholders to elect new directors by engaging in transactions that are designed and pursued for the primary purpose of diluting the votes held by the insurgent stockholders."); see also *Benihana of Tokyo, Inc. v. Benihana Inc.*, 891 A.2d 150, 189–90 (Del. Ch. 2005) (distinguishing *Packer* and *Condec* on grounds that in those cases, the share exchange did not bring in new capital, was negotiated in haste, and virtually assured the outcome of the vote).

¹³⁴ *Stahl v. Apple Bancorp*, 579 A.2d 1115, 1124 (Del. Ch. 1990).

¹³⁵ *Freedman v. Restaurant Assoc. Indus., Inc.*, No. 9212, 1987 Del. Ch. LEXIS 498, at *26 (Del. Ch. Oct. 16, 1987) ("I take it to be established in our law that it would ordinarily be found to constitute an abuse of power for a board of directors to issue stock, not for the principal purpose of raising necessary or desirable capital, but for the sole or primary purpose of diluting the voting power of an existing block of stock.").

¹³⁶ *Thorpe v. CERBCO, Inc.*, No. 11713, 1993 Del. Ch. LEXIS 257, at *27 n.16 (Del. Ch. Oct. 29, 1993) (referring to parenthetical summarizing *Phillips v. Insituform*).

Mendel v. Carroll,¹³⁷ while rejecting the plaintiff's motion to force the issuance of a stock option that would dilute the controlling shareholder's stake sufficiently for the other shareholders to accept an alternative transaction, the court left open the possibility that a board of directors might, when acting "in good faith and on the reasonable belief that a controlling shareholder is abusing its power and is exploiting or threatening to exploit the vulnerability of minority shareholders,"¹³⁸ be justified in granting "an option to buy stock for the principal purpose of affecting the outcome of an expected shareholder action, such as an election, a consent solicitation, or a tender offer."¹³⁹

Could one therefore argue, for example, that while § 251 gave Bear Stearns shareholders the right to vote on a merger, they were on notice that their shares could be diluted, and that, in extraordinary circumstances, even substantial dilution for the purpose of affecting the shareholder vote may be valid? The problem that arises here, however, is that under existing Delaware case law, it is very difficult to see any legitimate basis for the Bear Stearns board's attempt to deprive its existing shareholders of the ability to vote down the first \$2 per share merger, and potentially reject the renegotiated \$10 per share deal. There was no claim that the Bear Stearns shareholders who were opposed to the J.P. Morgan transaction were motivated by anything other than their interest in maximizing the value of their Bear Stearns investment. Bear Stearns may argue that it had to enter into the SEA, and thus lock up the deal, to induce J.P. Morgan to increase its offer from \$2 to \$10. But the fact is that Delaware law requires shareholder approval for mergers, and so far Delaware courts have not embraced the argument that a board can effectively evade this shareholder approval requirement (by issuing a lockup block to one's merger partner) as long as the merger premium is high enough and the merger partner insists on it. This is not to say that a Delaware court, faced with this case, could not have upheld the SEA on some ground. Surely it could have. But to do so would have significantly changed or destabilized existing Delaware doctrine.

The second, somewhat newer line of Delaware cases, beginning with *Schnell v. Chris-Craft Industries Inc.*,¹⁴⁰ continuing through *Blasius*,¹⁴¹ and reaffirmed in *Stroud v. Grace*¹⁴² and *MM Cos., Inc. v. Liquid Audio, Inc.*,¹⁴³

¹³⁷ 651 A.2d 297 (Del. Ch. 1994).

¹³⁸ *Id.* at 304.

¹³⁹ *Id.*

¹⁴⁰ 285 A.2d 437 (Del. 1971).

¹⁴¹ *Blasius Indus., Inc. v. Atlas Corp.* 564 A.2d 651 (Del. Ch. 1988).

¹⁴² 606 A.2d 75 (Del. 1992).

consistently protects the shareholders' franchise against board attempts to interfere with it. As the Delaware Supreme Court stated, when "boards of directors deliberately employ[] . . . legal strategies either to frustrate or completely disenfranchise a shareholder vote . . . [t]here can be no dispute that such conduct violates Delaware law."¹⁴⁴ Such intentional interference, under *Blasius* and its progeny, is illegal *even if the board acted in good faith* unless it has a "compelling" justification. This raises the question whether *Blasius* applies to the SEA and, if it does, whether the Bear Stearns board had the compelling justification needed to survive *Blasius*.

As a threshold inquiry, one would have to resolve whether *Blasius* applied to the SEA. It is clear that the SEA did, and was intended to, render the stockholder vote on the merger an empty formality, and thus fits squarely into the set of actions that constitute intentional interference with shareholders' franchise. What is less clear, however, is whether and how *Blasius* applies to shareholder votes other than elections for directors.

Dicta in *Blasius* itself suggests that the standard applies to interference with *any* shareholder votes.¹⁴⁵ But some recent Chancery Court opinions have tried to limit the *Blasius* standard to director elections. Thus, in *Mercier et al. v. Inter-Tel, Inc.*, Vice Chancellor Strine, as one alternative basis for the holding that a postponement of a merger vote was valid, held that *Blasius* never applied to merger votes.¹⁴⁶ In another Chancery Court opinion involving a merger vote, Vice Chancellor Lamb held that *Blasius* applied only when self-interested or faithless fiduciaries act to deprive shareholders of a full and fair opportunity to participate in the matter and to thwart what appears to be the will of a majority of the shareholders.¹⁴⁷ The court proceeded to uphold a board decision to change the record date for the merger because such a change did not deprive shareholders of a full and fair opportunity to participate in the merger vote. By contrast, in *State of Wisconsin Investment Board v. Peerless*

¹⁴³ 813 A.2d 118 (Del. 2003).

¹⁴⁴ *Stroud*, 606 A.2d at 91, cited and quoted with approval in *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1379 (Del. 1995).

¹⁴⁵ See, e.g., *Blasius*, 564 A.2d at 659–60 ("That is, a decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and the agent, has authority with respect to a matter of internal corporate governance. That, of course, is true in a very specific way in this case which deals with the question who should constitute the board of directors of the corporation, but it will be true in every instance in which an incumbent board seeks to thwart a shareholder majority.")

¹⁴⁶ See, e.g., *Mercier et al. v. Inter-Tel, Inc.*, 929 A.2d 786, 808–09 (Del. Ch. 2007) (holding that *Blasius* does not apply to a merger vote; in the alternative, *Blasius*'s compelling interest test is satisfied).

¹⁴⁷ *In re MONY Group, Inc.*, 853 A.2d 661 (Del. Ch. 2004).

System Corp., Chancellor Chandler, after concluding that the board had acted with the “primary purpose [of] . . . interfer[ing] with the shareholder vote,” applied the *Blasius* standard to a vote on a shareholder proposal.¹⁴⁸

The upshot is that there is an unresolved conflict in the Chancery Court as to whether and how *Blasius* applies in the merger context. Vice Chancellor Strine’s opinion in *Mercier* is in tension with the “compelling corporate purpose” language used in the share issuance cases discussed above in contexts that go well beyond elections of directors. Under Chancellor Chandler’s and Vice Chancellor Lamb’s tests, whether *Blasius* would apply to the SEA, and how this understanding fits with the share issuance cases, is less clear. Unlike a postponement of the record date upheld by Vice Chancellor Lamb, the SEA clearly deprived the other Bear Stearns shareholders of a full and fair opportunity to participate in the merger vote. More problematic is whether the SEA was executed by self-interested or faithless fiduciaries. While the Bear Stearns board seems to have had no conflict of interest, a board action that both intentionally interferes with the shareholder franchise and deprives stockholders of a full and fair opportunity to participate in the merger vote may, by itself, render the board faithless under Vice Chancellor Lamb’s and Chancellor Chandler’s tests. As Chancellor Chandler stated in *Peerless*, “The fiduciary duty of loyalty between a board of directors and the shareholders of a corporation is always implicated where the board seeks to thwart the action of the company’s shareholders.”¹⁴⁹ This is in keeping with the fundamental point of *Blasius*, namely, that a board, *even in good faith*, cannot intentionally interfere with shareholder franchise absent a compelling purpose.¹⁵⁰

Assuming *Blasius* does apply, there is little Delaware law on what circumstances could establish a compelling justification. In *Blasius* itself, none was shown. In dicta, Chancellor Allen suggested that the standard could possibly be met in a situation in which interfering with the shareholders’ franchise was necessary to protect the shareholders from coercion.¹⁵¹ Similarly, in the later Delaware Supreme Court case of *Liquid Audio*,¹⁵² no compelling justification was shown and the issue of what may constitute a

¹⁴⁸ No. 17637, 2000 Del. Ch. LEXIS 170, at *12 (Del. Ch. Dec. 4, 2000).

¹⁴⁹ *Id.* at *44.

¹⁵⁰ See generally *Blasius*, 564 A.2d 651.

¹⁵¹ There seem to be only two cases in which a compelling justification was found, and in each case, only in the alternative. See *Hollinger Int’l Inc. v. Black*, 844 A.2d 1022, 1089 (Del. Ch. 2004); *Inter-Tel*, 929 A.2d at 810.

¹⁵² *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003).

compelling justification was not discussed.¹⁵³ But even though there is little case law on what constitutes a compelling justification under *Blasius*, it clearly is meant to be a strict standard. As *Blasius* itself holds, a good faith belief by directors to be acting in the best interest of the corporation is not enough. And as a later Supreme Court case explains, the *Blasius* standard is very hard to meet.¹⁵⁴

What “compelling justifications” plausibly existed here for a device that effectively precluded shareholders from exercising their governance rights? One might argue that the magnitude of the increase from the original price to the amended merger price—from \$2 per share to \$10 per share—is so large as to create a compelling justification. But this is a difficult claim to sustain because the increase is only large relative to the \$2 price, not the recent market price or the trading price of the shares over the preceding year. The fact that J.P. Morgan was so keen to lock up the deal at \$10 per share, and had in fact paid up to \$12.23 per share for additional shares in the market, likewise indicates that the price was not compellingly rich.

What about the pressing need to close the deal to avoid a potential collapse of the financial system? The discussion in *Blasius*, including Chancellor Allen’s hypothetical, suggests that compelling interests need to be compelling

¹⁵³ Similarly, in an earlier case discussed in *Blasius*, Chancellor Allen had enjoined a board issuance of stock in an attempt to dilute the voting power of a controlling shareholder, holding that no justification for such an extraordinary step had been shown. *Blasius*, 564 A.2d at 662; see also *Phillips v. Insituform of N. Am., Inc.*, No. 9173, 1987 Del. Ch. LEXIS 474 (Del. Ch. Aug. 27, 1987).

¹⁵⁴ See *Williams v. Geier*, 671 A.2d 1368, 1376 (Del. 1996) (“*Blasius*’ burden of demonstrating a ‘compelling justification’ is quite onerous, and is therefore applied rarely.”). The very stringency of the *Blasius* standard has limited its application, and has led courts to work hard to avoid characterizing actions as “disenfranchisement.” *Inter-Tel*, 929 A.2d at 806 n.45 (citing *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1122–23 (Del. Ch. 1990)); see *Stroud v. Grace*, 606 A.2d 75 (Del. 1992); *Chesapeake Corp. v. Shore*, 771 A.2d 293, 322–23 n.58 (Del. Ch. 2000); William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1314 n.107 (2001).

The one opinion running somewhat to the contrary is the recent Chancery Court case *Inter-Tel*, in which the board delayed a shareholder vote on a merger. 929 A.2d 786. Vice Chancellor Strine held that *Blasius* did not apply to the board action. *Id.* at 818. He proceeded, however, to hold in the alternative that the board’s good faith action met the standard, at least as to a short delay, because the shareholders were about to act against their own interests, they had not had sufficient time to digest new information, and the acquirer would likely walk away if the shareholders voted no. *Id.* at 819. “When directors act for the purpose of preserving what the directors believe in good faith is a value-maximizing offer, they act for a compelling reason in the corporate context.” *Id.* The alternative holding in *Inter-Tel* has to be viewed in light of the peculiar nature of the board action, which amounted only to a small brake on the shareholders’ ability to take action, necessitated by the need to analyze new information, but which left the ultimate decision in the shareholders’ hands.

shareholder or *corporate* interests.¹⁵⁵ To be sure, the *Blasius* compelling justification standard, undefined as it is, could include pressing national interests. Whether it does, of course, represents another novel issue of Delaware law. This being said, the notion that the board of directors is permitted, in the exercise of its fiduciary duties, to take into account not just the interest of the company's shareholders, creditors, and other constituents, but the interests of parties who have no relationship whatsoever to the corporation is completely alien to Delaware law.

But even if *Blasius* does not technically apply, it is unclear what follows. Some Delaware precedent suggests that even under *Unocal/Unitrin*, the same "compelling justification" test would apply.¹⁵⁶ Thus, the Delaware Supreme Court stated in *Stroud*, "A board's unilateral decision to adopt a defensive measure touching 'upon issues of control' that purposefully disenfranchises its shareholders is strongly suspect under *Unocal*, and cannot be sustained without a 'compelling justification.'"¹⁵⁷ Whether this dictum in *Stroud* will be followed in other cases is yet another important question under Delaware law.

D. The Best Argument in Support of the Deal: The "Zone of Insolvency"

How, then, might the Amended Merger Agreement and the SEA be defended under Delaware law? The strongest argument that could be made is that, because Bear Stearns was on the verge of insolvency, the independent and nonconflicted board had additional discretion to act to ensure that the corporation would be able to meet its obligations to its creditors, employees, and customers, even at some cost to shareholders.¹⁵⁸ Going back at least to the *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.* case in 1991, Delaware courts have made clear that when a corporation is operating "in the vicinity of insolvency, a board of directors is not merely the agent of the residue [sic: residual] risk bearers, but owes its duty to the corporate enterprise."¹⁵⁹ In that case, the court held, the board had an obligation "to the community of interest that sustained the corporation, to exercise judgment in

¹⁵⁵ See *Blasius*, 564 A.2d at 659 (stating that the board may take certain steps "in good faith pursuit of a corporate interest").

¹⁵⁶ *Inter-Tel*, 929 A.2d at 810-11.

¹⁵⁷ *Stroud*, 606 A.2d at 92 n.3.

¹⁵⁸ See *Prod. Res. Group L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004); *Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm'ns Corp.*, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991); see also *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 100 (Del. 2007) (citing and discussing *Production Resources* favorably).

¹⁵⁹ *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at *108 & n.55.

an informed, good faith effort to maximize the corporation's long-term wealth creating capacity,"¹⁶⁰ rather than merely to maximize the benefit to be obtained by the shareholders.

As Vice Chancellor Strine explained in *Production Resources Group, L.L.C. v. NCT Group, Inc.*, the *Credit Lyonnais* case, despite some of the scholarly commentary and a few court decisions, was not about expanding creditors' rights or providing them with a new cause of action, but rather was about recognizing that the business judgment rule protects directors in choosing a less risky course of action: "In other words, *Credit Lyonnais* provided a shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk so long as the company would not technically breach any legal obligations."¹⁶¹

So, too, in the case of Bear Stearns, the board would argue that the firm was on the ropes; that the one chance to save it from bankruptcy was the deal with J.P. Morgan; that, although shareholders were understandably upset, there was really no alternative to the Amended Merger Agreement including the SEA; and that the doctrine announced in *Credit Lyonnais* would shield it from an attack by shareholders that it pursued an action that did not maximize shareholder benefit.

This argument, however, seems somewhat misdirected in the Bear Stearns context. First, a recent Delaware Supreme Court decision has clarified that the board's duty shifts only when a corporation is *actually* insolvent. As the court recently held:

When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation *for the benefit of its shareholder owners*.¹⁶²

Second, at least based on publicly available information, it is quite uncertain whether in fact Bear Stearns was insolvent (or, for that matter, within the zone of insolvency) on March 24, at the time of the Amended Merger

¹⁶⁰ *Id.* at *109.

¹⁶¹ *Prod. Res.*, 863 A.2d at 788.

¹⁶² *Gheewalla*, 930 A.2d at 101 (emphasis added). It should be noted that *Gheewalla* arose in the context of creditor standing and may not herald a retrenchment of *Credit Lyonnais* in the context of business judgment rule protection of board conduct.

Agreement. The price J.P. Morgan paid (about \$1.45 billion¹⁶³), and J.P. Morgan's eagerness to assure approval of the deal at that price, are both inconsistent with a claim of insolvency.¹⁶⁴ The events leading up to the Amended Merger Agreement also cast factual doubt on a claim of insolvency. To be sure, on March 16, when the original Merger Agreement was signed, Bear Stearns was in dire straits: it faced a "run on the bank" and impending bankruptcy if its customers and counterparties could not be assured of its liquidity.¹⁶⁵ But the March 16 deal, combined with the J.P. Morgan financing commitment and the Federal Reserve commitment to purchase \$30 billion in illiquid securities from the previous Friday, provided sufficient liquidity for the company to continue doing business.¹⁶⁶ As of March 17, therefore, the immediate liquidity crisis was averted, Bear Stearns's stock price stabilized at about \$5 per share,¹⁶⁷ and the market attention turned from the impending collapse of the financial system to the merits of the J.P. Morgan deal. The Amended Merger Agreement, with its \$10 price for Bear Stearns, was the result of a belief that the Bear Stearns board had given the company away for too little and J.P. Morgan's accompanying fear that shareholders would vote down the deal.¹⁶⁸ If Bear Stearns had truly been insolvent at that point, a shareholder threat to vote against the \$2 deal would not only have lacked credibility, it would not have induced J.P. Morgan to quintuple the offer price within the span of a few days.

That the \$2 deal negotiated on March 16 was a steal for J.P. Morgan, and that the \$10 deal on March 24 was still pretty good, is also underlined by the stock price movements of J.P. Morgan. On March 17, the first trading day after the \$2 deal was announced, J.P. Morgan's stock price increased by over 10% from \$36.54 to \$40.31.¹⁶⁹ Between March 17 and March 24, when the \$10 deal was locked up, J.P. Morgan's stock price increased by a further 15%

¹⁶³ Bear Stearns Cos., Inc., Information Required in Proxy Statement (Form 14A), at 3 (Mar. 18, 2008), available at <http://www.secinfo.com/dRSm6.t7p.htm#1stPage> (145 million shares outstanding).

¹⁶⁴ A positive share price, standing by itself, does not necessarily indicate that the company is not insolvent at the time. Shareholders may hope for an improvement in the company's fortunes before the creditors have to be paid, or to extract some value from even an insolvent entity through bargaining in bankruptcy. In the context of Bear Stearns, however, it would be odd for a solvent company like J.P. Morgan to acquire Bear Stearns for \$1.45 billion if Bear Stearns were insolvent.

¹⁶⁵ See Kelly, *Fears*, *supra* note 14.

¹⁶⁶ Kelly, *Neared Collapse*, *supra* note 14.

¹⁶⁷ Bear Stearns—Stock Price History, MSN Money, [http://moneycentral.msn.com/investor/charts/chartdl.aspx?Symbol=BEAR STEARNS](http://moneycentral.msn.com/investor/charts/chartdl.aspx?Symbol=BEAR%20STEARNS) (last visited Nov. 28, 2008).

¹⁶⁸ See Kelly, *Neared Collapse*, *supra* note 14.

¹⁶⁹ *Id.*

to \$46.55.¹⁷⁰ Over this period, the market capitalization of J.P. Morgan increased by \$34 billion—surely a figure hard to square with the theory that J.P. Morgan had just spent \$1.5 billion to acquire an insolvent company.¹⁷¹

Third, the shareholders' complaint is not that choosing the J.P. Morgan deal was, itself, a breach of the duty of care because it did not secure the highest price. Rather, the claim is that the SEA interfered with shareholders' *governance* rights—specifically, their statutory right to approve or reject a merger. Indeed, in *Credit Lyonnais*, Chancellor Allen noted in a footnote, “*But cf. Blasius Industries Inc. v. Atlas Corp.*, Del. Ch., 564 A.2d 651 (1988) (board action intended to impede stockholder exercise of statutory franchise right is suspect even if taken in good faith effort to promote corporate welfare).”¹⁷² After all, shareholders' right to approve or reject a merger is statutory, not simply an implication of the normal case of directors owing fiduciary duties to the corporation and its shareholders. The board should not be permitted, under the guise of advancing the interest of the corporation and its creditors, to undermine this statutory right of the corporation's shareholders.

Indeed, *Omnicare* involved a firm on the brink of insolvency¹⁷³ in which the controlling shareholders, acting in good faith and without conflict of interest, committed to a merger that assured that all creditors would get paid, and in which all shareholders were treated equally. If a board were permitted to undermine shareholder voting rights for the good of the creditors of such a company, one would have expected the Delaware Supreme Court to have awarded the *Omnicare* directors a medal. Instead, the Delaware Supreme Court enjoined the voting agreements because they undermined the shareholder vote, rendering it a mere *fait accompli*. It is extremely hard to see how a judge could uphold the SEA on the zone of insolvency theory without first overruling *Omnicare*—which, despite its flaws, remains binding on the Delaware Chancery Court (as well as on any foreign court applying Delaware law).

¹⁷⁰ *Id.*

¹⁷¹ The S&P 500 index slightly declined on March 17 and increased by less than 5% between March 17 and March 24. S&P 500 Index—Price History (Mar. 17–Mar. 24, 2008), MSN Money, <http://moneycentral.msn.com/investor/charts/chartdl.aspx?symbol=SPY> (enter date range as March 17, 2008, to March 24, 2008; then click on “Redraw Chart”) (last visited Jan. 22, 2009).

¹⁷² *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, 1991 Del. Ch. LEXIS 215, *109 n.56 (Del. Ch. Dec. 30, 1991).

¹⁷³ *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

Upholding the SEA on the basis that Bear Stearns was nearly or actually insolvent when it was entered into, and that this potential insolvency permits the board to ride roughshod over shareholders' governance rights, thus raises a host of factual and doctrinal difficulties. While this may be the best of the several bad ways to uphold the SEA, it would not present an easy way out for Delaware courts.

E. The Forty Percent Exception

Another even less persuasive argument could be made in support of the SEA. One defense can be discerned in some newspaper reports. The *New York Times* reported:

In an unusual move, Bear's board was seeking to authorize the sale of 39.5 percent of the firm to J.P. Morgan in an effort to move closer to majority shareholder approval. Under state law in Delaware, where the companies are incorporated, a company can sell up to 40 percent without shareholder approval.¹⁷⁴

In another account, it was said that

takeover practitioners have generally advised that as long as a deal was theoretically possible, Omnicare wasn't implicated. Delaware practitioners have settled on the "40 percent rule" to set a limit on how high you could go on a lock-up. Hence the 39.5 percent figure in Monday's deal with Bear.¹⁷⁵

To start with, the first report was incorrect when it referred to a forty percent rule in Delaware law. Rather, as the second quote correctly reports, this refers to a practitioners' rule of thumb with regard to the applicability of *Omnicare*. As discussed above, in *Omnicare*, the Delaware Supreme Court held that locking up the votes of 60% of the shares impermissibly rendered merger approval a *fait accompli*. But what percentage of the votes *can* be locked up *without* triggering *Omnicare*? The case, of course, did not say.

If one reads *Omnicare* as holding that you cannot lock up a "controlling" percentage of the votes—a reasonable reading as, in *Omnicare*, it was the votes of the controlling shareholders that were locked up and that rendered the outcome a *fait accompli*—then the business planner's question becomes "What

¹⁷⁴ Andrew Ross Sorkin, *J.P. Morgan in Negotiations to Raise Bear Stearns Bid*, N.Y. TIMES, Mar. 24, 2008, at A1.

¹⁷⁵ Steven Davidoff, *Is JPMorgan Getting Too Clever?*, N.Y. Times Deal Book: The Deal Professor (Mar. 24, 2008), <http://dealbook.blogs.nytimes.com/2008/03/24/is-j.p.morgan-getting-too-clever>.

is the minimum percentage that gives control?” Here, the answer based on the existing cases is that, while there are a variety of cases in a variety of contexts finding control between 40% and 50% of the shares, there are no cases finding control below 40%.¹⁷⁶

But, as a defense of the SEA, this is a pretty weak argument. First, *Omnicare* and the related case law all involved shareholders who *already* owned a controlling position. By contrast, in Bear Stearns, it is the Bear Stearns board, through the SEA, that unilaterally gave J.P. Morgan its overwhelming stock holding. Second, the notion that anything short of 40% does not amount to a *fait accompli* may be practitioner lore but it is not Delaware law (notwithstanding a single opinion by a respected judge). Third, there is no suggestion in the case law that one can issue up to 40% of the company’s stock in a lockup without running afoul of *Unocal/Unitrin*. Fourth, and most importantly, under the SEA, J.P. Morgan was permitted to, and did, acquire far more than 40%: it immediately purchased another 5% of Bear Stearns stock and then raised its stake to 49.73% of the outstanding shares over the next few weeks—a level which gave de facto control.¹⁷⁷

F. Summary

In the end, therefore, we believe that to uphold the SEA, the Delaware courts would have had to engage in significant factual or doctrinal contortions. Even if *Blasius* did not apply, a conclusion that could be reached on existing precedent, the SEA would have had to survive *Unocal/Unitrin*, *Omnicare*, and *Condec*. To get there, the courts could either have overruled *Omnicare* (as

¹⁷⁶ Thus, for example, in management buyout cases in which the question is whether the *Kahn v. Lynch* entire fairness standard applies, 40% seems to be the lower bound. *Kahn v. Lynch Commc’n Sys.*, 638 A.2d 1110 (Del. 1994). In *Kahn*, Alcatel owned 43.3% of Lynch’s outstanding stock and was, in fact, restricted to appointing a minority of the directors of Lynch. *Id.* at 1112. In *In re Cysive*, the shareholding group, depending on how you counted shares and options, had somewhere between 41% and 44% ownership, which, according to the court, was sufficient to trigger entire fairness. *In re Cysive, Inc.*, 836 A.2d 531, 535 (Del. Ch. 2003). By contrast, in *In re Western National*, 46% ownership was not enough to trigger entire fairness. *In re W. Nat’l Corp.*, 2000 WL 710192, at *29 (Del. Ch. May 22, 2000).

There are other cases that are consistent with this 40% line. For example, in *IXC*, then-Vice Chancellor (now Chief Justice) Steele, who dissented in *Omnicare*, held that agreements locking up 40% of the votes did not “make the outcome of the vote a foregone conclusion.” *In re IXC Commc’ns, Inc.*, No. 17334, 1999 WL 1009174, at *8 (Del. Ch. Oct. 27, 1999). In *ACE v. Capital Re*, a case involving a topping bid and the question whether Capital Re should be enjoined from talking with the competing bidder, the fact that ACE controlled nearly 46% of the shares outstanding going into the merger vote counted strongly toward interpreting the merger agreement to permit Capital Re to talk with other potential bidders. *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 111 (Del. Ch. 1999).

¹⁷⁷ See *supra* note 53 and accompanying text.

noted, it was a split opinion and widely criticized) or limited it to instances in which the controlling shareholder had an actual majority (and not just 49.7%) of the stock. In addition, the courts would have had to hold that a 39.5% share issuance, coupled with no restrictions on further acquisitions, and accompanied by an actual purchase of another 10% of the stock within days or weeks, was not a preclusive and coercive device—a ruling that would not only be ridiculous, but which would greatly expand the permissible scope of defensive devices. Alternatively, the courts could have found that the special circumstances of the case—the national interest—permitted the board to engage in conduct that would otherwise violate its fiduciary duties, which would have introduced a novel and alien concept into Delaware corporate law. Or they could have found that, despite J.P. Morgan's eagerness to acquire Bear Stearns for \$1.5 billion, Bear Stearns was insolvent, and held, as a matter of first impression (and at least implicitly inconsistent with *Omnicare* and dicta in *Credit Lyonnais*), that the board of an insolvent company can coerce shareholders into approving a deal that it finds in the overall best interest of shareholders and creditors. Such a resolution, in our view, would be questionable both on the interpretation of the facts and in the merits of the new doctrine it would create, but could still have been the least bad of the ways to uphold the SEA.

III. DELAWARE'S DILEMMA

The Amended Merger Agreement and the SEA thus placed Delaware on the horns of a dilemma. On the one hand, the SEA was pretty clearly invalid under current Delaware law. On the other hand, how could Delaware even contemplate enjoining a transaction that was supported, indeed, arguably driven and financed by the Federal Reserve with the full support of the Treasury—a transaction that may have been necessary to prevent a collapse of the international financial system? What would happen if a Delaware court enjoined the merger? Would the Federal Reserve or the Treasury or the defendants seek to remove the case to federal court (on some theory)? How could little Delaware insist on shareholders' right to veto a merger when so much depended on the merger's approval? Suppose that Delaware enjoined the merger, Bear Stearns failed, and the international financial system did, in fact, collapse. While upholding the SEA would involve a host of problems, risking the collapse of the financial system by invalidating the SEA could provoke exactly the kind of attention to Delaware's lack of political legitimacy

that would induce doubts about Delaware's ability to handle its role as maker of national corporate law—a severe threat to Delaware's franchising business.

This was the dilemma that faced Vice Chancellor Donald Parsons when he was assigned the Delaware portion of the Bear Stearns litigation.¹⁷⁸ As the earlier timeline indicated, on March 17 and 18, four separate class actions were filed in New York, with a fifth filed on March 20. On March 20 and 24 (the day that the Amended Merger Agreement and SEA were announced), two class actions were filed in Delaware. On March 27, the defendants moved to stay the Delaware action in favor of the New York actions.¹⁷⁹ In this Part, we first discuss the general approach Delaware has taken in deciding whether to stay an action involving Delaware corporate law. We then turn to Vice Chancellor Parson's ruling in the *Bear Stearns* case.

A. Delaware's Role in Adjudicating Delaware Corporate Law

In deciding whether to stay a Delaware action, Delaware considers a variety of factors. When the Delaware action is the only action filed and the stay is sought on the grounds of forum non conveniens, Delaware rarely grants such relief.¹⁸⁰ When a parallel action has been filed in another court, Delaware first examines whether the Delaware action was filed first, the other action was

¹⁷⁸ *In re Bear Stearns Cos., Inc. S'holder Litig.*, No. 3643-VCP, 2008 Del. Ch. LEXIS 46 (Del. Ch. Apr. 9, 2008).

¹⁷⁹ There is a separate and interesting question as to why the defendants preferred a New York forum. From a purely doctrinal perspective, they would be better off in Delaware. As discussed above, the case that presented the most serious obstacle to the validity of the SEA was *Omnicare*, a 3–2 decision of the Delaware Supreme Court. *Omnicare, Inc. v. NCS Healthcare, Inc.* 818 A.2d 914 (Del. 2003). In a Delaware forum, one could argue that *Omnicare* was wrongly decided and should be overruled. For example, in *Optima International of Miami, Inc. v. WCI Steel, Inc.*, Vice Chancellor Lamb characterized *Omnicare* as being “of questionable continued vitality.” *Recent Delaware Corporate Law Decisions and the 2008 Amendments to the General Corporation Law of the State of Delaware* (Richards, Layton & Finger, Wilmington, DE), July 31, 2008, <http://www.rlf.com/richardsnews/corpNewsletter073108-1.html>. No opinion was written in that case. On the other hand, because there have been no Delaware Supreme Court opinions casting any doubt on *Omnicare's* validity, it is hard to see the basis by which a New York forum could do anything other than take *Omnicare* as stating current Delaware law—without any way to take judicial notice of the controversy over *Omnicare's* continued validity.

Only a Delaware chancellor, with a full and confident grasp of Delaware doctrine and experience adjudicating high stakes corporate battles, would have had the self-confidence even to consider enjoining such a merger. *See, e.g., In re IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001) (ordering specific performance of a \$3 billion merger); Scott Kilman & Robin Sidel, *Judge Rules Against Tyson in IBP Takeover Case*, WALL ST. J., June 18, 2001, at A3. Our guess is that it was this consideration that ultimately drove the defendants' decision to seek adjudication in a New York forum.

¹⁸⁰ *McWane Cast Iron Pipe Corp. v. McDowell-Wellman Eng'g Co.*, 263 A.2d 281, 283 n.2 (Del. 1970).

filed first, or the cases were filed contemporaneously.¹⁸¹ Delaware considers cases filed within a few days of each other to have been filed contemporaneously.¹⁸²

When the non-Delaware action was filed first, Delaware applies the *McWane* test.¹⁸³ Under *McWane*, a decision to grant a stay should be exercised freely in favor of a prior action so long as that action involves the same parties and issues and the other court is capable of doing prompt and complete justice.¹⁸⁴

In contrast, when the two actions were filed contemporaneously or the Delaware action was filed first, a Delaware court will use the forum non conveniens factors in deciding whether to stay the action.¹⁸⁵ In that analysis, Delaware will consider the standard factors:

- 1) the applicability of Delaware law, 2) the relative ease of access to proof, 3) the availability of compulsory process for witnesses, 4) the pendency or non-pendency of a similar action or actions in another jurisdiction, 5) the possibility of a need to view the premises; and 6) all other practical considerations that would make the trial easy, expeditious, and inexpensive.¹⁸⁶

This doctrinal framework governs stay motions in Delaware generally, regardless of whether the case involves Delaware corporate law or other matters.¹⁸⁷ However, in cases involving Delaware corporate law, the factors play out differently. Our review of stay decisions in corporate law cases decided in the last five years reveals the following pattern:

- (i) When the non-Delaware action was filed first and the action relates to a corporation that is not publicly traded, Delaware will generally stay the Delaware action;¹⁸⁸

¹⁸¹ See, e.g., *In re Bear Stearns*, 2008 Del. Ch. LEXIS 46, at *2.

¹⁸² *Id.*

¹⁸³ See *McWane*, 263 A.2d at 283.

¹⁸⁴ *Id.*; see *Adirondack GP, Inc. v. Am. Power Corp.*, No. 15060, 1996 Del. Ch. LEXIS 143, at *18–*19 (Del. Ch. Nov. 13, 1996).

¹⁸⁵ *In re Bear Stearns*, 2008 Del. Ch. LEXIS 46, at *16.

¹⁸⁶ *Ryan v. Gifford*, 918 A.2d 341, 351 (Del. Ch. 2007) (quoting *In re Chambers Dev. Co., Inc.*, No. 12508, 1993 Del. Ch. LEXIS 79, at *6 (Del. Ch. May 20, 1993)); see also *In re Bear Stearns*, 2008 Del. Ch. LEXIS 46, at *16.

¹⁸⁷ See *Aveta, Inc. v. Colón*, 942 A.2d 603, 609 (Del. Ch. 2008).

¹⁸⁸ See, e.g., *Citirin Holdings LLC v. Cullen 130 LLC*, No. 2791-VCN, 2008 WL 241615, at *5 (Del. Ch. July 18, 2007).

- (ii) When the non-Delaware action was filed first but the action relates to a publicly traded corporation, Delaware will sometimes issue a stay (when special facts would make it inefficient to proceed in Delaware¹⁸⁹) and sometimes not;¹⁹⁰ and
- (iii) When the actions were filed contemporaneously or the Delaware action was filed first, Delaware will generally not issue a stay, especially if the action involves a publicly traded corporation.¹⁹¹

Within the last category, we found three actions involving public corporations. In each case, Delaware refused to stay the Delaware action.¹⁹² We found one action involving a nonpublic corporation in which Delaware issued a stay,¹⁹³ but that case involved two unusual facts. First, the same party instituted two actions in different courts.¹⁹⁴ Thus, the stay did not deprive the party instituting the Delaware action of its choice of forum.¹⁹⁵ Second, only the non-Delaware forum (Pennsylvania) had personal jurisdiction over one of the key defendants, who had been dismissed from the Delaware action for lack of jurisdiction.¹⁹⁶

When a Delaware court refuses to issue a stay, it frequently bases its decision on the first of the forum non conveniens factors, the applicability of Delaware law, and sometimes notes the importance of Delaware courts developing their case law, especially when the issues raised in the case are

¹⁸⁹ See, e.g., *Kaufman v. Kumar*, No. 2418-VCL, 2007 WL 1765617, at *3 (Del. Ch. June 8, 2007) (New York action filed two years before Delaware's); *Teachers' Ret. Sys. of La. v. Scrushy*, No. 20529, 2004 WL 423122, at *1-*2 (Del. Ch. Mar. 2, 2004) (Delaware action filed after plaintiffs in Alabama state and federal courts, together with plaintiffs in a prior Delaware action, had reached agreement on appointment of a steering committee, appointment of lead counsel, and supervised settlement discussions); *Brudno v. Wise*, No. 19953, 2003 WL 1874750, at *1 (Del. Ch. Apr. 1, 2003) (staying Delaware action where derivative Delaware claim hinged on the outcome of a securities claim in federal action and the federal courts had stayed the federal derivative action pending the disposition of the securities claim).

¹⁹⁰ See, e.g., *Ryan*, 918 A.2d at 349-50 (no stay because action involved novel and substantive issue of Delaware corporate law); *Biondi v. Scrushy*, 820 A.2d 1148, 1160-61 (Del. Ch. 2003) (no stay because previously filed complaint was cursorily pled).

¹⁹¹ See, e.g., *Brandin v. Deason*, 941 A.2d 1020, 1021 (Del. Ch. 2007); *In re Topps Co. S'holders Litig.*, 924 A.2d 951, 953 (Del. Ch. 2007); *Rapoport v. Litig. Trust of MDIP Inc.*, No. 1035-N, 2005 WL 3277911, at *8 (Del. Ch. Nov. 23, 2005).

¹⁹² *Brandin*, 941 A.2d at 1021; *In re Topps*, 924 A.2d at 953; *Rapoport*, 2005 WL 3277911, at *8.

¹⁹³ *Cornerstone Techs., LLC v. Conrad*, No. 19712-NC, 2003 WL 1787959, at *14-*15 (Del. Ch. Mar. 31, 2003).

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ *Id.*

novel and substantial.¹⁹⁷ Thus, for example, in *Ryan v. Gifford*, Chancellor Chandler denied a motion to stay an option-backdating case in favor of an earlier-filed case pending in federal court and held that

A similarly important factor in determining whether a stay is appropriate in a derivative action is a court's ability to render justice. Rendering justice necessarily entails accurately applying controlling law, in this case Delaware law. In many instances, this Court has recognized without hesitation that sister state courts and federal courts are capable of applying Delaware law and providing complete justice to parties. At the same time, however, Delaware courts have a "significant and substantial interest in overseeing the conduct of those owing fiduciary duties to shareholders of Delaware corporations." This interest increases greatly in actions addressing novel issues. In *In re Chambers Development Co.*, this Court noted, as it has in the past, that "novel and substantial issues of Delaware corporate law are best resolved in Delaware courts." Thus, while the application of Delaware law in most cases is not determinative, more weight must be accorded to this factor where the law is novel. Such is the case here.¹⁹⁸

Note that Delaware has taken a fairly broad view of what constitutes a novel or substantial issue. Thus, in *Rapoport v. Litigation Trust of MDIP Inc.*, Vice Chancellor Parsons found that the

action will likely raise at least one novel issue of Delaware corporate law: whether directors and officers' duties change materially in the face of "deepening insolvency." This action also raises "substantial issues" of Delaware corporate law. Indeed, the liability or lack thereof of the Directors will turn on their compliance with their duties of good faith and loyalty, as elucidated by the Delaware courts.¹⁹⁹

The Delaware practice we have described, we believe, reflects a view of the proper scope of Delaware jurisdiction held not only by the Delaware judiciary, but also shared by the corporate litigation bar and corporate law academics. This view takes as a starting point that publicly traded companies incorporate in Delaware (and pay its high franchise taxes) at least in part because of its

¹⁹⁷ *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, No. 8126, 1985 Del. Ch. LEXIS 545, at *4–*5 (Del. Ch. Oct. 9, 1985), cited in *In re Chambers Dev. Co.*, No. 12508, 1993 WL 179335, at *3 (Del. Ch. May 20, 1993).

¹⁹⁸ *Ryan v. Gifford*, 918 A.2d 341, 349–50 (Del. Ch. 2007) (citations omitted).

¹⁹⁹ *Rapoport v. Litigation Trust of MDIP Inc.*, No. 1035-N, 2005 WL 3277911, at *5 (Del. Ch. Nov. 23, 2005) (citations omitted).

high-quality and specialized courts and, as a general matter, want important and high-profile cases to be decided by Delaware judges. The Delaware court system rests on a highly respected Chancery Court that decides cases without juries and specializes in corporate law adjudication, combined with a Supreme Court that offers quick review and brings its own considerable expertise—three of the five current Delaware Supreme Court justices are former members of the Chancery Court, and all regularly hear appeals from the Chancery Court on corporate law issues. The Delaware Supreme Court and Chancery Court judges are not only experts, but are few in number and communicate regularly with each other and members of the corporate bar. In such a system, much of the shared understanding of Delaware doctrine resides between the lines of the judicial opinions.

Compounding these aspects of the court system, Delaware corporate law doctrine regularly employs open-ended, highly fact-specific standards that are difficult to apply by any judge who does not regularly adjudicate corporate law disputes.²⁰⁰ It is a doctrine that works well for the Delaware courts—because of the volume of cases and the small number and expertise of its judges—but much less so if judges of other courts are asked to apply it. As a result, any issue arising under Delaware corporate law where the correct outcome is not obvious is best decided by Delaware’s judiciary.

Indeed, despite the fact that Delaware courts pay lip service to the ability of other courts to decide Delaware corporate law cases (and let them decide cases involving nonpublic corporations that are usually low profile and unimportant to the development of Delaware doctrine), the fundamental view that non-Delaware judges should not decide important issues under Delaware corporate law is occasionally revealed. Thus, again in *Rapoport*, Vice Chancellor Parsons explained that “[s]uch questions of substantive Delaware corporate law ‘are more properly decided here rather than another jurisdiction.’”²⁰¹ In *Brandin*, Vice Chancellor Lamb, after first noting that “federal courts are quite capable of deciding cases involving Delaware corporate law,”²⁰² proceeded to quote then-U.S. Supreme Court Justice White for the proposition that federal courts would have “the unavoidable tendency . . . ‘to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within

²⁰⁰ See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1102 (1997).

²⁰¹ *Rapoport*, 2005 WL 3277911, at *5 (quoting *In re Walt Disney Co.*, No. 15452, 1997 WL 118402, at *3 (Del. Ch. Mar. 13, 1997)).

²⁰² *Brandin v. Deason*, 941 A.2d 1020, 1027 (Del. Ch. 2007).

the federal system.”²⁰³ And in another notable case, *In re Topps Co.*, Vice Chancellor Strine noted that in Delaware, only

ten judges are involved in [corporate law] decisions, avoiding phenomena such as “circuit splits” and expressed concern that the important coherence-generating benefits created by [the Delaware judiciary] . . . are endangered if . . . decisions are instead routinely made by a variety of state and federal judges who only deal episodically with our law.²⁰⁴

In case someone missed the point, he then quoted at length from an article by our colleague Bob Thompson praising the Delaware courts for the unmatched coherence of Delaware’s fiduciary duty law.²⁰⁵

The refusal by Vice Chancellor Strine to stay the Delaware action in *Topps* is especially noteworthy because, as in the *Bear Stearns* case, the non-Delaware action was pending in the New York Supreme Court in front of Justice Cahn.²⁰⁶ Despite Vice Chancellor Strine’s suggestion that New York respect Delaware’s superior interest and stay its action—including a quote from Judge Learned Hand, “one of New York’s most distinguished jurists,” that ““when a trial involve[s] the internal affairs of a corporation, the rule is that the courts of a foreign forum will not assume jurisdiction over it”²⁰⁷—Justice Cahn refused to issue a stay.²⁰⁸ He held that, under New York law, when the action was filed in New York first—even if only by a day—and New York has a substantial nexus with the case, New York should never stay, even in favor of the state of incorporation.²⁰⁹ For Justice Cahn, then, a decision to incorporate in Delaware did not reflect a choice by the corporation and its shareholders of Delaware as the preferred forum for adjudicating corporate law disputes which should be accorded significant weight.

Justice Cahn’s reasoning has the potential to significantly undermine Delaware’s ability to resolve disputes. In virtually *every* dispute, another state will have a stronger factual nexus to the action than Delaware’s. After all, Delaware is rarely the state in which companies are headquartered, financial

²⁰³ *Id.* (quoting *Sante Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977)).

²⁰⁴ *In re Topps Co. S’holders Litig.*, 924 A.2d 951, 959 (Del. Ch. 2007).

²⁰⁵ *See id.* at 958 n.24 (quoting Robert V. Thompson, *Piercing the Veil: Is the Common Law the Problem?*, 37 CONN. L. REV. 619, 628 (2005)).

²⁰⁶ *In re Topps Co. S’holder Litig.*, No. 600715/07, 2007 N.Y. Misc. LEXIS 8973, at *1 (N.Y. Sup. Ct. June 8, 2007).

²⁰⁷ *In re Topps Co.*, 924 A.2d at 959 (quoting *Weiss v. Routh*, 149 F.2d 193, 195 (2d Cir. 1945)).

²⁰⁸ *In re Topps Co.*, 2007 N.Y. Misc. LEXIS 8973, at *7.

²⁰⁹ *Id.*

advisors are located, deals are negotiated, board meetings are held, or the key documents and witnesses are located. Indeed, given New York's status as the financial capital, most cases will have a stronger nexus to New York than to Delaware. Were Justice Cahn's reasoning accepted, no case would be adjudicated in Delaware when a non-Delaware action had been filed one day (or even one hour) before the Delaware action.

Delaware's ability to rule on cases raising questions of Delaware corporate law is a matter of enormous consequence to Delaware. In the short term, reducing Delaware's ability to rule on such cases would diminish its attractiveness as the state of incorporation and reduce the income of Delaware's corporate litigation bar, an important political constituency. In the long term, the consequences would be even more drastic. Delaware law would be less developed (due to the smaller number of cases), possibly become less coherent (due to the presence of decisions decided by other courts), and its judiciary could lose part of its expertise (due to the smaller number of cases heard). From Delaware's perspective, Justice Cahn's approach constitutes a virtual declaration of war on its corporate law adjudication.

B. The Delaware Motion for a Stay

As a matter of Delaware law and practice, therefore, it would have been quite straightforward for Vice Chancellor Parsons to deny the motion to stay. After all, this was a case in which the parties themselves, in the Amended Merger Agreement and the SEA, had explicitly contracted for Delaware law *and* a Delaware forum.²¹⁰ Moreover, as the discussion above shows, the case presented questions at least as novel and substantive as those cited in prior cases as justification for a refusal to issue a stay. Thus, a refusal to stay this high-profile case involving a publicly traded corporation would be consistent with the intention of the parties, with Delaware doctrine, and with Delaware's past practice. By contrast, yielding to Justice Cahn's assertion of New York adjudicative authority in a case involving the internal affairs of a Delaware corporation would not be a viable long-term strategy for Delaware.

But Vice Chancellor Parsons stayed the Delaware action. In doing so, he made several arguments. First, he stated:

²¹⁰ Bear Stearns Cos. Inc., Agreement and Plan of Merger (Form 8-K, Exh. 2.1), at 38 (Mar. 24, 2008), available at <http://www.secinfo.com/dRSm6.t8b.d.htm#1stPage>; March 24 Exhibit, *supra* note 80, at 7–8.

Despite Plaintiffs' protestations to the contrary, the claims asserted in the Complaint only require the application of well-settled principles of Delaware law to evaluate the deal protections in the merger and the alleged breaches of fiduciary duty. There is no dispute that these principles will be applied by some court. Although the facts of the case are unusual, the uniqueness of facts does not transform settled law into new or novel legal issues.²¹¹

This, we assert, is disingenuous. Some of the relevant principles are hardly settled: the split decision in *Omnicare* is one of the most controversial opinions to be issued by the Delaware Supreme Court in years; the applicability of *Blasius* to merger cases is unresolved; the scope of the "compelling justification" exception under *Blasius* is almost completely undefined; and the scope and content of a zone of insolvency defense is especially unclear in light of the recent *Gheewalla* case. And even with respect to purportedly settled principles, this case raised the question of whether a court should unsettle those principles to permit a transaction to proceed which is arguably necessary to maintain the stability of the financial system and, if so, on what basis and with what limits. One might think that the expert Delaware judiciary should decide these questions.

Vice Chancellor Parsons then added:

Moreover, several facts make it unlikely this extraordinary situation will recur or have wide application. Indeed, Christopher Cox, Chairman of the Securities and Exchange Commission, in reported testimony before a Congressional Committee characterized Bear Stearns' failure to obtain financing even though it had "high quality collateral" as "an unprecedented occurrence."²¹²

This, we submit, is a makeweight. The fact that it was unprecedented did not mean that it would not recur. Subsequent events—the collapse of Lehman Brothers and the government bailouts of AIG, GM, and Chrysler—reveal that the *Bear Stearns* matter, while perhaps unprecedented, was not unique. Subsequent developments further emphasize the importance of the core issue presented for Delaware corporations: to what extent may dire circumstances justify a board's good faith usurpation of shareholders' statutory right to approve a merger by issuing a large block of shares to a merger partner?

²¹¹ *In re Bear Stearns Cos., Inc. S'holder Litig.*, No. 3643-VCP, 2008 Del. Ch. LEXIS 46, at *21 (Del. Ch. Apr. 9, 2008).

²¹² *Id.* at *21–*22 (citation omitted).

As yet another basis for the stay, Vice Chancellor Parsons asserted:

That is not to say . . . that the issues of Delaware law presented by this dispute are not important; in fact, such issues ordinarily would be heard in this Court. Rather, I find the circumstances of this case to be *sui generis*. What is paramount is that this Court not contribute to a situation that might cause harm to a number of affected constituencies, including U.S. taxpayers and citizens, by creating the risk of greater uncertainty.²¹³

The logic of this argument is somewhat unclear. The procedural posture of the case, with parallel actions filed in two fora, is common and surely not *sui generis*. What makes this case *sui generis* is the significance of the Bear Stearns–J.P. Morgan transaction for the stability of the financial system. But if this aspect of the case is legally irrelevant—if the outcome under Delaware law is not and should not be affected by it—then the fact that this aspect is *sui generis* should also have no impact on the decision to stay. After all, each case involves facts that are *sui generis* in some sense, yet legally irrelevant. If, on the other hand, this aspect is, or is arguably, legally relevant, then the case raises novel issues and therefore cannot be governed by well-settled principles of Delaware law. And the presence of novel issues is a factor that, under Delaware stay jurisprudence, would weigh heavily in favor of having the case heard in a Delaware court.

Moreover, it is unclear why a failure to stay the case would create the risk of greater *uncertainty*. First, of course, this presupposes that New York would proceed with the case despite Delaware’s failure to stay. In *Topps*, Vice Chancellor Strine refused a stay and left New York to decide for itself what to do.²¹⁴ In *Bear Stearns*, Vice Chancellor Parsons might have done the same thing.

But even assuming that Justice Cahn would not stay the New York action, proceeding in two fora rather than one does not materially increase *uncertainty*. The issue here arises at the intersection between parallel representative litigation, the U.S. Constitution’s Full Faith and Credit

²¹³ *Id.* at *23.

²¹⁴ See *In re Topps Co. S’holders Litig.*, 924 A.2d 951, 956 (Del. Ch. 2007). The New York court denied the defendants’ motion for a stay. *In re Topps Co. S’holder Litig.*, No. 600715/07, 2007 N.Y. Misc. LEXIS 8973, at *7 (N.Y. Sup. Ct. June 8, 2007).

Clause,²¹⁵ and the parallel federal Full Faith and Credit Statute.²¹⁶ Before final judgment, rulings of one court do not bind a court of a sister state.²¹⁷ By contrast, after a final judgment, straightforward application of the rule of res judicata generally bars the relitigation of the case in the sister state's court.²¹⁸ The Full Faith and Credit Clause, the Full Faith and Credit Statute, and the Uniform Enforcement of Foreign Judgments Act,²¹⁹ if applicable, provide additional compulsion to respect the first judgment.²²⁰ This set of rules has the obvious effect of providing an incentive for a race in which the first judgment will prevail against all subsequent judgments in parallel proceedings.²²¹

Within this framework, the most significant result of parallel Delaware and New York proceedings is to increase the likelihood of an injunction by giving plaintiffs the proverbial two bites at the apple: an injunction in either court will be binding on the parties, and a refusal to grant an injunction in either court will not bind the other court, because it is not a final judgment. This is presumably the main reason why J.P. Morgan wanted to stay the Delaware action. There is thus a limited and trivial sense in which a stay increases certainty: with a stay, J.P. Morgan only needs to win in New York; without a stay, J.P. Morgan must win in both New York and Delaware.

But even the possibility of conflicting rulings is more imagined than real. If Delaware were to rule first on the preliminary injunction motion (as it was urged to do by the plaintiffs during the oral argument on the stay²²²), it would take quite a bit of chutzpah for the New York trial court to correct the

²¹⁵ U.S. CONST. art. IV, § 1 ("Full Faith and Credit shall be given in each State to the public Acts, Records, and Judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof.").

²¹⁶ 28 U.S.C. § 1738 (2006) (requiring state courts to give judicial proceedings of other states "the same full faith and credit . . . as they have by law or usage in the courts of such State . . . from which they are taken"); see William T. Allen, *Finality of Judgments in Class Actions: A Comment on Epstein v. MCA, Inc.*, 73 N.Y.U. L. REV. 1149, 1155–56 (1998); Geoffrey P. Miller, *Overlapping Class Actions*, 71 N.Y.U. L. REV. 514, 533–34 (1996).

²¹⁷ See Miller, *supra* note 216, at 523–25.

²¹⁸ *Id.* at 525–26. Two principal exceptions apply: absent class members who have not had adequate notice and right to opt out, *Phillips Petrol. Co. v. Shutts*, 472 U.S. 797 (1985), and absent class members who can show that they were not adequately represented by class counsel in an initial proceeding, Miller, *supra* note 216, at 526. For a full discussion of these issues, see Tobias Barrington Wolff, *Federal Jurisdiction and Due Process in the Era of the Nationwide Class Action*, 156 U. PA. L. REV. 2035, 2117–31 (2008).

²¹⁹ UNIF. ENFORCEMENT OF FOREIGN JUDGMENTS ACT § 2, 13 U.L.A. 152 (1986).

²²⁰ Miller, *supra* note 216, at 526.

²²¹ *Id.* at 527.

²²² Transcript of Oral Argument at 32–33, *In re Bear Stearns Cos., Inc. S'holder Litig.*, No. 3643-VCP, 2008 Del. Ch. LEXIS 46 (Del. Ch. Apr. 9, 2008). If Delaware enjoined the SEA, the injunction motion in New York would become moot.

Delaware Chancery Court (or the Delaware Supreme Court, if it had affirmed) on its application of Delaware law to the facts at bar. Moreover, if one accepts the premise that Delaware courts are more likely to decide the case correctly, and further believes that the earlier Delaware ruling will affect any subsequent New York ruling, Delaware's decision to stay merely increased the likelihood of an *incorrect* outcome by letting New York proceed without first hearing the views of the Delaware Chancery Court.

But what if New York were to rule first or make a decision without regard to the prior Delaware ruling? Even then, a Delaware stay would affect the outcome only if Delaware would have granted the injunction and New York would not have granted one. (If New York would have granted an injunction, or if neither New York nor Delaware would have granted one, a Delaware stay would have no effect on the outcome.) In this specific circumstance, to be sure, a Delaware stay reduces the likelihood of the SEA being enjoined and benefits J.P. Morgan. But from a broader perspective, and assuming again that Delaware is more likely to decide the case correctly, a Delaware stay raises the likelihood of an incorrect ruling in this specific circumstance as well as in the case in which a prior Delaware ruling would affect the New York ruling. This combined effect—a lower likelihood of an injunction and a higher likelihood of an incorrect ruling—seems desirable to us only if one believes that it is more important to have the merger consummated than to arrive at the correct legal outcome.

Finally, Vice Chancellor Parsons noted:

[T]his case raises practical considerations far beyond the typical concerns. The practical considerations here include: two sets of plaintiffs in two fora; the risk that inconsistent rulings would negatively impact not only the parties involved, but also the U.S. financial markets and the national economy; and the involvement of unusual third party players, including, *inter alia*, the Federal Reserve Bank and the Department of the Treasury. Given these important and atypical practical considerations, this is the rare case where a stay may be appropriate.²²³

But this explanation is problematic. Stay motions often involve two sets of plaintiffs in two fora. That this case is highly important for the economy, as indicated by the involvement of Federal Reserve and Treasury officials, means not just that one should avoid the risk of inconsistent rulings (which, as

²²³ *In re Bear Stearns*, 2008 Del. Ch. LEXIS 46, at *28 (citations omitted).

explained before, is not so severe to start with and could be managed by having Delaware rule first), but that it is very important to get the case resolved correctly. Moreover, getting a difficult Delaware corporate law case resolved correctly is a factor that weighs heavily toward having it resolved by the Delaware Chancery and Supreme Court, and not within the New York state court system. At most, this argument supports an expedited schedule in Delaware.

Nevertheless, Vice Chancellor Parsons, when presented by the defendants with an opportunity to defer to another state, embraced it. And, in doing so, we argue, he made the right strategic decision for Delaware. The Bear Stearns dilemma placed Delaware in an impossible position. While it clearly could not—as a matter of prudent public policy and *Realpolitik*—enjoin the merger, upholding the SEA would have raised a host of its own problems. How to avoid the horns of the dilemma? Delaware hit on the perfect solution: avoid any decision at all!

By taking advantage of the pendency of actions in New York and the defendants' motion to stay, and by invoking the doctrine of comity to allow a New York trial court judge to decide a pure question of Delaware corporate law, Delaware managed to dodge both bullets. On the one hand, it could predict that the New York judge would not enjoin the transaction for a similar set of reasons that would lead Delaware to refrain from enjoining such a deal. On the other hand, any decision approving the merger would have no precedential value in Delaware and thus would not disturb its case law.²²⁴ And if the New York court were to distort the facts to reach such a decision, it would matter even less for Delaware.

Moreover, this strategy trumps the alternative ways of ducking the question. For example, Vice Chancellor Parsons could have refused to enjoin the vote and waited to see if J.P. Morgan's shares proved pivotal to the outcome. But what if, but for the J.P. Morgan shares, the merger did not receive shareholder approval (as in fact turned out to be the case)?²²⁵ Then he would have been stuck. Alternatively, he might have played for time, hoping the case would settle or otherwise go away. But this strategy would have at

²²⁴ As Gil Sparks, a leading Delaware lawyer representing Bear Stearns, argued to Vice Chancellor Parsons, "a preliminary ruling by a foreign court on Delaware law questions won't reshape our law. That is done by this Court and by our Supreme Court." Transcript of Oral Argument at 12, *In re Bear Stearns*, 2008 Del. Ch. LEXIS 46.

²²⁵ *In re Bear Stearns Litig.*, 2008 N.Y. Misc. LEXIS 7075, at **18 (N.Y. Sup. Ct. Dec. 4, 2008) (not counting the J.P. Morgan shares, the merger would have failed with a 42.7% vote).

least two further downsides: first, the settlement value would depend on the court's ruling on the shareholders' likelihood of success, so avoiding the issue might also impede settlement; second, it would undermine Delaware's well-deserved and highly valued reputation for speed.

Did Delaware suffer any damage from refusing to decide? Probably not. While it is true that Delaware cannot routinely defer to the courts of sister states on cases involving Delaware law without undermining its preeminent role as the authoritative interpreter of its own law, a rare exception hardly threatens that dominance. As expected, the New York court upheld the transaction: in December 2008, after the merger had closed, it dismissed the damages action on summary judgment.²²⁶ We do not expect that court's opinion to influence Delaware law.

IV. IMPLICATIONS FOR CORPORATE FEDERALISM

The shotgun marriage of Bear Stearns and J.P. Morgan, a match made by the Treasury and the Federal Reserve, presents a real-time case study of Delaware's place in the U.S. corporate lawmaking system. There are a number of lessons that can be drawn from the experience.

First, Delaware's treatment of the *Bear Stearns* litigation emphasizes the extent to which Delaware avoids the limelight in cases in which there is a danger of strong public criticism, a strategy that we have argued elsewhere reduces the risk of a backlash against Delaware's status as maker of de facto national corporate law.²²⁷ Just as being out front on the corporate scandals, à la Eliot Spitzer, would have been very dangerous for Delaware, so too, taking a leading role in the *Bear Stearns* matter would have been very dangerous, especially if something bad had happened.

Second, the *Bear Stearns* case posed particular problems for Delaware's determinedly old-fashioned, apolitical style of adjudication.²²⁸ Delaware's decisions derive part of their legitimacy from being perceived as technical and apolitical.²²⁹ In this regard, *Bear Stearns* was truly a no-win situation: enjoining the deal would have landed Delaware in the middle of political debate; not enjoining the deal could have been viewed by insiders as a

²²⁶ *Id.*

²²⁷ Kahan & Rock, *supra* note 4, at 1617–18.

²²⁸ *Id.* at 1611–15.

²²⁹ *Id.*

political, instead of legal, decision—detracting from Delaware’s continued legitimacy.

Third, the federal system, with numerous federal and state actors, permits Delaware to duck “hot potato” issues such as this one. Delaware sometimes finds it in its interest to duck such issues.²³⁰ But ducking issues carries risks of its own: duck too many and you become irrelevant. Delaware, as this case shows, thus finds itself performing a very delicate balancing act: it must maintain its centrality in corporate law while avoiding high-profile, politically charged, and potentially partisan controversies that could provoke a political reaction.

Finally, this case study highlights Delaware’s complex relationship with other states and stands as an exception. In general, Delaware is respectful to other states on matters outside what it views as core issues of Delaware law.²³¹ But Delaware also expects similar deference from other states with regard to matters that fall (in Delaware’s assessment) within its legitimate sphere. Delaware has a firm view that matters relating to the “internal affairs” of Delaware corporations fall within its sphere and has been quite hostile toward California’s or New York’s attempts to encroach.²³² Indeed, Delaware has argued that the internal affairs doctrine may be constitutionally mandated.²³³ Furthermore, as we have argued above, Delaware believes that its expert courts should decide “novel and substantial issues of Delaware corporate law.”²³⁴

As both *Topps* and *Bear Stearns* indicate, Delaware is on a collision course with New York. That collision will come sooner rather than later if New York adheres to Justice Cahn’s position that a New York court *may not* stay an action that was first filed in New York (even by a day), so long as there is a factual nexus to New York (and without regard to the state of incorporation). We expect that Delaware will largely ignore the refusal of New York to stay a first-filed action arising under Delaware law, and will proceed with its own process, while defending its ability to adjudicate claims by assuring that the Delaware case will be decided first and thus be entitled to receive full faith and

²³⁰ *Id.* at 1621.

²³¹ *See id.* at 1615.

²³² *See, e.g., In re Topps Co. S’holders Litig.*, 924 A.2d 951, 958–60 (Del. Ch. 2007); *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1115–16 (Del. 2005).

²³³ *VantagePoint Venture*, 871 A.2d at 1113.

²³⁴ *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, No. 8126, 1985 Del. Ch. LEXIS 545, at *2 (Del. Ch. Oct. 9, 1985).

credit in the New York courts. With the speed and expertise of its Chancery Court, Delaware should be able to win any “race to final judgment.”

But the *Bear Stearns* case was not the place to fight out that issue. The opportunity to dodge a bullet by letting Justice Cahn handle the case was sufficiently valuable for Delaware that it wisely chose to overlook what in other contexts would be viewed as overreaching by New York.

