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# Articles

## REFLECTIONS ON THE REVLON DOCTRINE

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### INTRODUCTION

As a matter of statutory law,<sup>1</sup> a Delaware corporation is managed and supervised by its board of directors.<sup>2</sup> As a matter of judge-made law

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1. DEL. CODE ANN. tit. 8, § 141 (2009). This section provides, in pertinent part:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

§ 141(a).

The managerial functions of directors can be divided into two broad areas: decision-making and supervision. In its decision-making role, the board determines matters of policy and makes the large decisions that chart the corporation's future. "Legally, the board itself [is] required to authorize the most significant corporate acts or transactions: mergers, changes in capital structure, fundamental changes in business, appointment and compensation of the CEO, etc." *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 968 (Del. Ch. 1996). In its supervisory function, the board monitors those assigned to carry out its decisions. *Id.* at 968.

2. *See, e.g.*, *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (holding that actions of the board, meeting certain criteria, will be evaluated under the lenient 'business judgment' standard of review); *In re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 363 (Del. Ch. 2008) (stating that shareholders challenging a merger must first confront the business judgment rule); *Orman v. Cullman*, 794 A.2d 5, 19 (Del. Ch. 2002) (citing the business judgment rule as a recognition of the precept that the board manages the business and affairs of the

derived from traditional principles of equity, directors perform these statutory duties subject to the fiduciary duties of loyalty and care.<sup>3</sup> The duty of loyalty requires directors to be guided by a reasonable belief that their actions will serve the best interests of the corporation and its stockholders.<sup>4</sup> The duty of care requires directors to act in an informed and deliberate manner.<sup>5</sup> This article focuses on judicial review of the board's performance of these duties in the context of approving business combinations<sup>6</sup> between the board's corporation and another corporation, an area largely governed by the *Revlon* doctrine.<sup>7</sup>

Traditionally, judicial review of a board's decision to approve a business combination is governed by the business judgment rule.<sup>8</sup> That rule prevents the court from reviewing the substantive merits of the decision unless the plaintiff can show that a majority of the decision-making directors lacked impartiality or failed to exercise due care.<sup>9</sup> In recent years, that has changed. Under current Delaware law, if a business combination is deemed to constitute a "sale of the company"<sup>10</sup> or a "sale of

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corporation).

3. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986). The Delaware General Corporation Law does not define directors' duties to the corporation or its shareholders. Rather, it leaves these duties to be defined under traditional principles of equity by the judges of the Delaware Supreme Court and the Delaware Court of Chancery.

4. *See Cede & Co., Inc. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (stating that this interest "takes precedence over any interest possessed by a director . . . and not shared by the stockholders generally.").

5. *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del 1985).

6. The term "business combinations" is used in this article to refer to transactions by which two corporations combine their assets and liabilities to create a single business entity. This can be accomplished in a single step by a long-form merger or in two steps by an agreed upon tender offer followed by a long- or short-form merger. A business combination may be deemed the acquisition of one corporation by another or a merger of equals.

7. The Delaware courts are a little inconsistent in their use of this label. The Delaware Supreme Court used it in *Malpiede v. Townson*, 780 A.2d 1075, 1084 (Del. 2001), and the Court of Chancery used it in *In re Lear Corp. S'holders Litig.*, 926 A.2d 94, 115 (Del. Ch. 2007) and *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 546 (Del. Ch. 2003). On the other hand, the Delaware Supreme Court has said that the use of such colloquial labels in judicial proceedings is inappropriate. *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1289 n.40 (Del. 1994); *see also* Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty Law After QVC and Technicolor: A Unified Standard (and the End of Revlon Duties?)*, 49 BUS. LAW. 1593, 1593-4 (1994) (noting the inappropriateness of such colloquialisms as "*Revlon* duties" and "*Revlon-land*" in judicial proceedings).

8. *Van Gorkom*, 488 A.2d at 872-73; *Cede*, 634 A.2d at 363.

9. *See Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1279 (Del. 1988) ("[W]hen a court reviews a board action, challenged as a breach of duty, it should decline to evaluate the wisdom and merits of a business decision unless sufficient facts are alleged with particularity, or the record otherwise demonstrates, that the decision was not the product of an informed, disinterested, and independent board.").

10. *See Revlon*, 506 A.2d at 182 (involving a sale of the company).

control”<sup>11</sup> it is governed by the *Revlon* doctrine. That doctrine makes two important changes. First, the board’s fiduciary duties are no longer focused on the long-term well-being of the corporation. Instead, its duties are aimed at serving the short-term interests of the stockholders in achieving a transaction that will maximize the immediate value of their shares.<sup>12</sup> These refocused duties are sometimes referred to as “*Revlon* duties”.<sup>13</sup> Second, if the board’s performance of these “*Revlon* duties” is challenged, the court will not defer to the board’s business judgment, even though the board’s independence, disinterestedness, and diligence would have earned such deference under the business judgment rule.<sup>14</sup> Instead, the court will review the decision with “enhanced scrutiny,” a procedure that requires independent, disinterested directors to prove<sup>15</sup>: (1) that their decision-making process was performed with adequate care;<sup>16</sup> and (2) that their decision was reasonable under the circumstances.<sup>17</sup>

In Part I, this article will explain the *Revlon* doctrine. Part II will focus on *Revlon* duties. The article will argue that the original *Revlon* decision correctly recognized that, in deciding whether to approve a business combination, the board’s fiduciary duties must be focused exclusively on the welfare of stockholders. But, subsequent applications of the holding in *Revlon*, which allowed a board to pursue a pending transaction in the face of an alternative transaction that would better serve the stockholders’ interests provided that the pending transaction does not involve a “change of control,”<sup>18</sup> are mistaken. The fact that a transaction will cause a change of control merely creates the opportunity to seek a control premium, an element of value that is intended to compensate the

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11. *See* *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 36 (Del. 1994) (involving the sale of control).

12. *See Revlon*, 506 A.2d at 182 (stating that when the break-up of a company is inevitable, the board’s duty changes from preserving the company “to the maximization of the company’s value at a sale for the stockholders’ benefit”).

13. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 928 (Del. 2003); *Paramount Commc’ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1989).

14. Employing a bit of linguistic sleight of hand, the court often says that they subject the transaction to enhanced scrutiny *before* they accord the transaction the favorable presumption of the business judgment rule. *QVC*, 637 A.2d at 45. But, this puts things backwards. The business judgment rule is a rule that prevents courts from examining the merits of the challenged transaction. *See infra* Part III.

15. *Omnicare*, 818 A.2d at 931 (“[T]he directors have the burden of proving that they were adequately informed and acted reasonably.” (quoting *QVC*, 637 A.2d at 45)).

16. *Id.* This inquiry focuses on the quality of the information and advice available to the directors and the care with which they reached their decision.

17. *Id.* This inquiry necessarily involves an examination of the substantive merits of the board’s decision because it asks whether the challenged decision was reasonably likely to enhance the price the corporation’s stockholders would receive for their shares.

18. *QVC*, 637 A.2d at 43 (Del. 1994).

stockholders who will sacrifice control.<sup>19</sup> This paper will argue that the board's duty as an agent for the stockholders requires it to consider other offers that may arise before the pending deal is consummated. Even when the pending deal is a stock-for-stock merger of equals, the board's duty as the stockholders' agent requires it to determine whether an alternative proposal would be of greater value to stockholders than the present value of the resulting corporation's long-term prospects. If the alternative proposal is better, the board's duty as the stockholders' agent would prevent it from recommending that the stockholders accept the less valuable pending deal.<sup>20</sup>

Part III of this article will examine the business judgment rule. Part IV traces the origins and evolution of enhanced scrutiny and concludes that enhanced scrutiny differs dramatically from the business judgment rule in two respects. First, under the business judgment rule, the burden is on the plaintiff to show that the directors failed to satisfy their duty of care.<sup>21</sup> Enhanced scrutiny has relieved the plaintiff of that burden, and instead requires the directors to prove that they followed an adequate decision-making process, a proof that amounts to showing their compliance with their duty of care. Second, under the business judgment rule, the court will not review the substantive merits of the challenged decision made by impartial directors who acted with due care. But, under enhanced scrutiny, the court will review the substance of the challenged decision to make sure it is "reasonable."<sup>22</sup>

Parts V and VI will show that courts apply enhanced scrutiny liberally in actions for injunctive relief but not in actions for damages. Part VII concludes with an argument for a return to the business judgment rule's policy favoring judicial deference to business decisions made by objective and diligent boards and argues that enhanced scrutiny is only appropriate where the circumstances suggest that the board's decision to approve a particular transaction may have been influenced by factors irrelevant to the

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19. *Id.*

20. *See* ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 97 (Del. Ch. 1999) (declining to enjoin stockholders from terminating a merger agreement because the harm to the company's stockholders outweighed the harm suffered by the company seeking the injunction).

21. *Cede*, 634 A.2d at 361; *Van Gorkom*, 488 A.2d at 889.

22. *Omnicare*, 818 A.2d at 931 (citing *QVC*, 637 A.2d at 45); *see also* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1385-86 (Del. 1995) (noting that the court does not demand that the directors' decision be the best one; rather, it merely requires that the decision be within a range of reasonable choices). In *QVC* the court candidly admitted that this required judges to review "the substantive merits of a board's actions." *QVC*, 637 A.2d at 45. *But see* Paul L. Regan, *The Unimportance of Being Earnest: Paramount Rewrites the Rules for Enhanced Scrutiny in Corporate Takeovers*, 46 HASTINGS L.J. 125, 127 (1994) (arguing that *Paramount's* formulation of the test for enhanced judicial scrutiny represents an unwarranted intrusion into the managerial authority of the board of directors).

best interests of the stockholders.

## I. THE TWO ELEMENTS OF THE REVLON DOCTRINE

Two important consequences flow from the determination that a transaction is governed by the *Revlon* doctrine.<sup>23</sup> First, the focus of the board's fiduciary duties shifts from the long-term well-being of the corporation to the short-term interests of the stockholders in achieving a transaction that will maximize the value of their shares.<sup>24</sup> These refocused duties are frequently referred to as *Revlon* duties.<sup>25</sup> Second, the Court will subject the board's performance of its *Revlon* duties to enhanced scrutiny, even though, under the business judgment rule, the decision would be entitled to judicial deference.<sup>26</sup>

Delaware's jurisprudence in this area has tended to conflate these two distinct aspects of the *Revlon* doctrine. As a result, the two concepts have become congruent.<sup>27</sup> When a transaction involves circumstances that shift the board's duties to the short-term interests of stockholders, the court will subject the board's decision to enhanced scrutiny.<sup>28</sup> But, not all circumstances that call for shifting the focus of the board's duties justify departure from the business judgment rule's policy of favoring judicial deference to business decisions that have been carefully made by impartial directors. Conversely, not all circumstances that call for enhanced scrutiny involve circumstances that require the board to focus solely on the stockholders' short-term interests.

This article will address these two elements separately.

## II. DUTY-SHIFTING

### A. *The Revlon Case*

In the now famous *Revlon* case,<sup>29</sup> the court reviewed a decision by

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23. See *supra* note 8 for a discussion of the Delaware courts' inconsistent use of this label.

24. *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1284 (Del. 1989) ("*MacMillan II*"); see also *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.").

25. *Omnicare*, 818 A.2d at 921; *Time*, 571 A.2d at 1150.

26. *MacMillan II*, 559 A.2d at 1287-88; *In re Lear Corp. S'holder Litig.*, 926 A.2d 94, 115 n.19 (Del. Ch. 2007); *In re Topps Co. S'holder Litig.*, 926 A.2d 58, 93 n.31 (Del. Ch. 2007).

27. See *Regan*, *supra* note 23, at 181-85.

28. *In re Pennaco Energy, Inc. S'holder Litig.*, 787 A.2d 691, 705 (Del. Ch. 2001).

29. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

Revlon's board to "sell the company"<sup>30</sup> to a white knight, Forstmann-Little & Co.<sup>31</sup> The sale was intended to block Pantry Pride's bid to acquire control of Revlon.<sup>32</sup> Pantry Pride responded to the white knight deal by increasing the price of its all-cash, all-shares offer and announcing that it would engage in fractional bidding to top any price offered by Forstmann-Little.<sup>33</sup> Revlon's directors, unwilling to see their company fall into the hands of Pantry Pride, modified the agreement with Forstmann-Little to raise its price slightly above Pantry Pride's latest offer and to insert certain deal protection measures that would create a financial deterrent to a higher bid by Pantry Pride.<sup>34</sup> Undaunted, Pantry Pride made a higher offer, contingent on the removal of the deal protection measures.<sup>35</sup> At the same time, Pantry Pride brought an action in Delaware's Court of Chancery seeking an injunction against enforcement of the deal protection measures. Pantry Pride argued that the board's approval of these deal protection measures violated its fiduciary duties to Revlon's stockholders because these measures prevented Revlon's stockholders from accepting Pantry Pride's financially superior offer.<sup>36</sup>

The court held that the board's decision to "sell the company" meant "[t]he duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit."<sup>37</sup> As a consequence, the directors were no longer "defenders of the corporate bastion," but had become "auctioneers charged with getting the best price for the stockholders at a sale of the company."<sup>38</sup> Because the deal protection measures prevented Revlon's stockholders from accepting Pantry Pride's superior offer, they were inconsistent with the board's duty to maximize the immediate value of their shares.<sup>39</sup>

*Revlon* recognized that when a board undertakes to negotiate a "sale of

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30. *Id.* at 182 (noting that the authority given by the board to management to negotiate "a merger or buy-out with a third party was a recognition that the company was for sale").

31. *Id.* at 183 (noting that Forstmann-Little was acting as a "white knight").

32. *Id.* at 175.

33. *Id.* at 178.

34. *Id.* at 178-79. The revised agreement included, among other things, the following: (1) A "lock-up" option that gave Forstmann-Little the right to purchase one of Revlon's "crown jewel" divisions at a significantly discounted price (approximately 80% of value) if Pantry Pride acquired more than 40% of Revlon's shares; (2) A "no-shop" provision that would prevent Revlon's directors from seeking higher priced bids; and (3) A "cancellation fee" of \$25 million to be placed in escrow and paid to Forstmann-Little if Revlon terminated the agreement. *Id.*

35. *Id.* at 179.

36. *Id.* at 182.

37. *Id.*

38. *Id.*

39. *Id.* at 176.

the company,”<sup>40</sup> the focus of the board’s fiduciary duties shifts from serving the well-being of the corporation to serving the stockholders interest in maximizing the immediate value of their shares.<sup>41</sup> The problem has been to define with greater precision the circumstances that require a board to focus its duties exclusively on the immediate maximization of shareholder value.<sup>42</sup> The issue is important because once it is determined that a transaction has the effect invoking “Revlon duties” the board must “treat all other interested acquirers on an equal basis.”<sup>43</sup> Thus, a board that is subject to Revlon duties has no principled basis for rejecting an unsolicited, higher priced third-party offer.<sup>44</sup> This can create a practical problem for a board that believes that a business combination with a particular corporation would be in their corporation’s best long-term interests. If agreeing to such a business combination is deemed by a court to have invoked *Revlon* duties, an unsolicited offer at a higher price may force the board to abandon those plans to allow the company’s stockholders to maximize the immediate value of their shares.<sup>45</sup>

*B. Time-Warner’s Definition of When Revlon Governs*

In *Time-Warner*,<sup>46</sup> the Delaware Supreme Court attempted to narrowly define the circumstances that would invoke *Revlon* duties. The dispute in that case began when Time, Inc. and Warner Communications, Inc., agreed to combine their two companies in a stock-for-stock “merger

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40. *Id.* at 182.

41. *Id.*

42. The circumstances that invoke “Revlon duties” are sometimes referred to as “Revlon land”. *In re NCS Healthcare, Inc. S’holders Litig.*, 825 A.2d 240, 262 (Del. Ch. 2002); *McMillin v. Intercargo Corp.*, 768 A.2d 492, 502 (Del. Ch. 2000); *Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95, 107 (Del. Ch. 1999). It is mildly interesting that the Vice-Chancellors used this colloquialism in their judicial opinions subsequent to the Supreme Court’s admonition against their use.

43. *Paramount Commc’ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1149 (Del. 1989).

44. *See Revlon*, 506 A.2d at 182 (holding that directors must maximize shareholder profit when a company’s breakup is inevitable); *QVC*, 637 A.2d at 44 (Del. 1994) (stating that the directors’ primary responsibility in the sale of control context is maximizing shareholder value).

45. *See QVC*, 637 A.2d at 47 (holding that the board’s fiduciary duties to stockholders prevented it from locking up a pending deal that would effectuate a change of control when a better deal was potentially available); *McMullin v. Beran*, 765 A.2d 910, 919-920 (Del. 2000) (finding *Revlon* duties were implicated where the board agreed to sell the entire company even though the merger would not cause a change of control).

46. 571 A.2d at 1140. The decision of the Supreme Court of Delaware in this case is commonly referred to as the “Time-Warner” decision because the challenged transactions addressed by the court involved the merger of Time, Inc. with Warner Communications, Inc. *Id.*

‘of equals.’”<sup>47</sup> The stockholders of each corporation would become stockholders of the resulting corporation and would, therefore, participate in the long-term benefits to be achieved by the merger. The stock of both companies was publicly traded, as would be the stock of the resulting corporation.<sup>48</sup>

Shortly before the special stockholders meeting at which Time’s stockholders were to vote on the merger, Paramount, in an effort to prevent Warner, its competitor in the entertainment industry, from gaining the competitive advantage it would achieve by merging with Time, made an unsolicited, all-cash tender offer to acquire Time.<sup>49</sup> Paramount’s offer was priced well above the current trading price of Time’s stock.<sup>50</sup> Time’s board, realizing that its stockholders would vote against the merger because they preferred the more valuable Paramount cash offer, asked Warner to restructure the transaction to avoid the necessity of a shareholder vote, and Warner agreed.<sup>51</sup>

Paramount and Time stockholders brought suit arguing, among other things, that the original Time-Warner merger would constitute a “sale of the company.” By approving this transaction, they argued, Time’s directors had taken on *Revlon* duties which required them to allow Time’s stockholders to accept Paramount’s more valuable tender offer.<sup>52</sup> The Delaware Supreme Court rejected that argument because the Time-Warner merger did not fit within any of the circumstances that had thus far implicated *Revlon* duties.<sup>53</sup>

Unfortunately, the court did not provide a principled analysis of a legal doctrine or policy that would require the directors to shift the focus of their fiduciary duties from serving the best interests of the corporation to seeking a transaction that would maximize the immediate value of the company’s shares. Instead, the Court merely described some of the facts of the three<sup>54</sup> cases<sup>55</sup> in which *Revlon* duties had been held to be applicable.

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47. *Id.* at 1145.

48. *See* Paramount Commc’ns, Inc. v. Time, Inc., Nos. 10866, 10670, and 10935, 1989 WL 79880, at \*8 (Del. Ch. 1989) (describing the stock-for-stock nature of the merger between the two companies).

49. *Time-Warner*, 571 A.2d at 1147.

50. *Id.* Paramount initially offered to acquire all of Time’s stock at \$175 in cash. *Id.* Paramount subsequently raised its offer to \$200 per share. *Id.* at 1149. The trading price of Time’s shares immediately before Paramount announced its offer was \$126 per share. *Id.* at 1147.

51. *Id.* at 1148. Under the restructured transaction, Time would make a highly leveraged tender offer to acquire just over fifty percent of Warner’s stock and then combine the two companies in a second-step merger in which the consideration would be cash and debt securities. *Id.*

52. *Id.* at 1149.

53. *Id.* at 1150-51.

54. *Id.* In its opinion, the court said there were two such circumstances, but it actually

These cases involved the “breakup of the corporation,”<sup>56</sup> the “reorganization of the corporation,”<sup>57</sup> and an effort to sell the corporation at auction<sup>58</sup>.

### 1. Breakup of the Corporation

The first<sup>59</sup> of the three circumstances identified in *Time-Warner* occurs when the board decides, in response to a takeover bid, to abandon the corporation’s “long-term strategy and seeks an alternative transaction involving the breakup of the company.”<sup>60</sup> In support of this, the court cites its earlier decision in *Revlon*.<sup>61</sup> The court explains that the directors’ duties shifted because they approved a “‘bust-up’ sale of assets in a leveraged acquisition.”<sup>62</sup>

The court’s emphasis on the buyer’s use of leverage to finance the acquisition and the buyer’s plans to sell certain corporate assets to help pay off the debt may have resonated with critics of takeovers who decried the “bust-up” culture of corporate America in the 1980s, but it does not provide a principled reason to explain why a board’s duty would shift from long-term planning for the benefit of the corporation to short-term value maximization for the benefit of the shareholders. The fact that an acquirer uses borrowed money to purchase a corporation’s stock is irrelevant to the stockholder who receives cash in exchange for his shares. To the stockholder, borrowed cash is the same as earned cash. Similarly, the fact that the acquirer may sell off corporate assets to repay part of the debt is also irrelevant to the stockholders. When the acquisition is complete, the stockholders will no longer have an equity interest in the corporation. The corporation will belong to the acquirer, who will thus have the right to dispose of its assets as it pleases. Neither the source of the acquirer’s financing nor its post-acquisition plans for the corporation provides a principled reason to require directors to focus their duties exclusively on the immediate maximization of shareholder value. Indeed, if anything, an

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described three. *Id.*

55. The cases concerned are: *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Macmillan I*, 552 A.2d 1227 (Del. Ch. 1988), and *Macmillan II*, 559 A.2d 1261 (Del. 1989).

56. *Time-Warner*, 571 A.2d at 1150.

57. *Id.*

58. *Id.*

59. The order in which these are presented is the reverse of the order in which the court discussed them. This order was chosen because it follows the chronological sequence of judicial decisions from which the examples are taken.

60. *Time-Warner*, 571 A.2d at 1150.

61. *Id.*

62. *Id.*

acquirer's plans to breakup the company would only be relevant in a circumstance where the board's fiduciary duties were focused on the long-term welfare of the company.

## 2. Reorganization of the Corporation

The second circumstance identified in the Time-Warner decision occurs when a corporation initiates "a business reorganization involving a clear break-up of the company."<sup>63</sup> In support of this, the court cites *MacMillan II*.<sup>64</sup> That case involved the first chapter in the saga involving Macmillan Corporation's efforts to defend itself from hostile takeover bids. The saga began when the board of MacMillan responded to an unsolicited takeover bid by approving a reorganization plan that would divide the company into two separate corporations.<sup>65</sup> One corporation would contain MacMillan's information business; the other corporation would contain its publishing business. MacMillan's shareholders would receive shares in each corporation, and MacMillan's senior managers would end up owning a controlling block of stock in each.<sup>66</sup>

At the time of the board's decision, MacMillan's financial advisors estimated that the company was worth between \$72.57 and \$80 per share.<sup>67</sup> After restructuring, shares would be worth \$64.15,<sup>68</sup> a value that was less than the \$73 per share takeover bid.<sup>69</sup> The Court of Chancery held that the board's duties in this circumstance were defined by *Unocal* and *Revlon*.<sup>70</sup> Because the restructuring prevented MacMillan's shareholders from accepting the more valuable takeover bid, the court concluded that the board had violated its *Unocal* duties, and thus by implication, its *Revlon* duties.<sup>71</sup>

The Time-Warner decision offers no explanation of why the reorganization of a corporation into separate corporations would impose an obligation on directors to maximize the immediate value of the corporation's shares. Indeed, corporations are usually reorganized to

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63. *Id.*

64. *Id.* (citing *MacMillan II*, 559 A.2d 1261). For an explanation of the "break-up" transaction, see *MacMillan I*, 552 A.2d 1227 (Del. Ch. 1988).

65. *MacMillan I*, 552 A.2d at 1234-35.

66. *Id.* at 1236-37.

67. *Id.* at 1236.

68. *Id.* Other financial advisors opined that the value of the restructuring was between sixty-three and sixty-eight dollars per share. *Id.*

69. *Id.* at 1237.

70. *Id.* at 1238.

71. *Id.* at 1238-39. The Chancellor explained that the reorganization was not a reasonable response to the Bass Brothers' takeover bid because it was worth less than the Bass Brothers' offer and it allowed the inside managers of MacMillan to acquire control of the desirable information business without paying a takeover premium. *Id.* at 1241-44.

improve their long-term prospects.

### 3. Auction for the Company

The third circumstance occurs “when a corporation initiates an active bidding process seeking to sell itself.”<sup>72</sup> In support of this, the court cites *MacMillan II*.<sup>73</sup> *MacMillan II* dealt with the second and final chapter in the MacMillan saga. After the Court of Chancery enjoined the proposed restructuring, the MacMillan board decided to hold an auction and sell the corporation to the highest bidder.<sup>74</sup> At the end of the auction, the board approved a leveraged buyout by a group led by Macmillan’s senior management.<sup>75</sup> The unsuccessful bidder challenged the board’s decision. The Delaware Supreme Court affirmed the chancery court’s holding that the sale to the management leveraged-buyout group violated *Revlon* because the auction had been corrupted to favor the management group and thus denied stockholders a higher bid that would have been available had the auction been run fairly.<sup>76</sup>

This makes sense. Like any auctioneer, the Macmillan board owed its fiduciary duties to the owners of the property being sold. That duty required the board to get the highest available price.<sup>77</sup> The owners of the corporation are the stockholders. So, of course, the board’s fiduciary duty as an auctioneer required it to conduct the auction in a way that would achieve the best available deal for the stockholders.

#### C. Ownership Decisions Invoke Revlon Duties.

The noted corporate commentator, Bayless Manning,<sup>78</sup> adopted a distinction between board decisions that involve “enterprise” issues and those that involve “ownership” issues as a way of identifying circumstances in which the Delaware courts would be willing to deviate from the business judgment rule’s principle of judicial deference and examine the merits of a board’s decision.<sup>79</sup> That distinction also provides a

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72. *Time-Warner*, 571 A.2d at 1150.

73. *Id.*

74. *MacMillan II*, 559 A.2d at 1272.

75. *Id.* at 1277-78.

76. *Id.* at 1282-84.

77. *Id.* at 1282.

78. Professor Manning served as a Professor of Law at Yale, as Dean of Stanford Law School, as executive director of the Council on Foreign Relations, and as a member of the New York law firm of Paul, Weiss, Rifkind, Wharton & Garrison. See Yale Law School’s Center for the Study of Corporate Law, available at <http://www.law.yale.edu/cbl/modertera.htm> (last visited January 23, 2009).

79. See Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom*

useful way to identify the circumstances that require the board to focus its fiduciary duties on the maximization of immediate shareholder value.

“Enterprise” issues are raised by questions having to do with the ongoing operation of the corporation. A board decision to expand the corporation’s business into a new geographic market would be an example of an “enterprise” decision.<sup>80</sup> “Ownership” issues, on the other hand, arise when the matter to be decided will directly affect the stockholders’ ownership interest in the corporation.<sup>81</sup> In Manning’s words, these issues are raised by transactions that “hit [the stockholder] directly in his role as an ‘owner,’ not ‘owner of the corporation’ as legal doctrine would have it, but owner of his own reified piece of property, *his* share of stock.”<sup>82</sup> A cash-for-stock merger, which converts the shares of stock owned by the corporation’s stockholders into cash, is an example of such a transaction.

When considering an enterprise issue, the directors’ duties are focused on serving the best interests of the corporation. But, when considering an ownership issue, one that will affect the stockholders’ property interest in the corporation’s shares, the directors’ duties should be focused on the best interests of the stockholders, and that interest is served by maximizing the value of their property, the corporation’s shares.

### 1. Termination of Stockholders’ Equity Participation

The board’s duty to achieve the best available price for the shares held by the corporation’s stockholders is clearest in the context of a transaction that involves a “sale of the company,” the type of transaction at issue in the *Revlon* case. The colloquialism “sale of the company,” refers to a business combination that has the effect of terminating the stockholders’ equity participation in their corporation. This can be accomplished by a merger in which the stockholders’ shares are canceled and the stockholders receive cash or non-equity securities in consideration for their cancelled shares,<sup>83</sup> or it can also be accomplished by a two-step process that begins with a

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*After Van Gorkom*, 41 BUS. LAW. 1, 6 (1985) (distinguishing “ownership” decisions from “enterprise” decisions—ownership decisions involve choices that involve selling one’s own property or someone else’s property, which would require the owner’s permission).

80. *Id.* at 6 (describing various examples of enterprise decisions); *see also* Regan, *supra* note 23, at 195 (reviewing the distinction between enterprise and ownership decisions and providing examples of enterprise decisions); E. Norman Veasey, *The New Incarnation of the Business Judgment Rule in Takeover Defenses*, 11 DEL. J. CORP. L. 503, 505 (1986) (discussing enterprise decisions).

81. *See* Manning, *supra* note 80, at 6 (describing ownership decisions); *see also* Regan, *supra* note 23, at 195 (same).

82. Manning, *supra* note 80, at 5-6.

83. *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858, 866-67 (Del. 1985) (outlining a leveraged buyout by management in a cash-out merger); *McMillan v. Intercargo Corp.*, 768 A.2d 492, 496 (Del. Ch. 2000) (discussing the share price offered in a cash-out merger).

tender offer to acquire the company's shares in consideration of cash or non-equity securities and ends with a squeeze-out merger in which any remaining shares are eliminated for cash or non-equity securities.<sup>84</sup>

The transaction in *Revlon* invoked the board's duty to maximize the immediate value of the stockholders' shares because it would terminate the stockholders' equity participation in the company. The board was negotiating the terms of a merger in which stockholders would receive cash in exchange for their shares.<sup>85</sup> This put the board in a position in which it was required to function like an agent selling articles of personal property, the shares of the corporation's stock, which belonged to its principals, the corporation's stockholders. Like any agent, a board in such a situation owes its principals fiduciary duties of loyalty and care.<sup>86</sup> The duty of loyalty requires the board to achieve the best available price for the stockholders' shares. The duty of care requires it to be informed of all reasonably available relevant information and to exercise reasonable care in its decision-making throughout the sales process.

Because the transaction will terminate the shareholders' equity participation, it marks their last chance to profit from their investment in the corporation.<sup>87</sup> The fact that the business combination might achieve some long-term benefit for the corporation is, to its stockholders, irrelevant. For them, there will be no tomorrow.<sup>88</sup> Accordingly, in the context of a sale of the company, (i.e., a transaction that terminates the stockholders' equity participation in the enterprise) long-term benefits to be achieved by the merger are unimportant to the stockholders. Because the board is functioning as the agent of the stockholders, it must focus exclusively on the immediate maximization of shareholder value.

## 2. Stock-Swap Transactions

A transaction that constitutes the sale of the company is different from a business combination in which the stockholders of the constituent corporations will receive stock in the combined business entity. Such a combination can be accomplished by a merger in which the stockholders' shares are converted into shares of the resulting corporation.<sup>89</sup> It can also

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84. See, e.g., *Paramount Commc'ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 40 (Del. 1994) (describing a two-step merger).

85. *Revlon*, 506 A.2d at 178.

86. It is for this reason that a *Revlon* claim can be brought as a direct cause of action rather than as a derivative action. *Gatz v. Ponsoldt*, No. 174-N, 2004 WL 3029868, at \*7 (Del. Ch. Nov. 5, 2004).

87. *McGowan v. Ferro*, 859 A.2d 1012, 1032 (Del. Ch. 2004).

88. *Id.*

89. See, e.g., *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 63-65 (Del. 1995) (describing merger negotiations involving various ratios of stock to be exchanged for shares

be accomplished by a two-step process that begins with a tender offer in which the offeror seeks to exchange shares of the resulting corporation for the stockholders' shares and ends with a squeeze-out merger in which any remaining shares are cancelled and the holders receive shares of the resulting corporation in exchange.<sup>90</sup> The significant difference between a stock-swap transaction and a sale of the company is that, in the stock-swap transaction, the stockholders will have an ongoing equity participation in the entity into which the businesses were combined.

*a. Merger of Equals*

A stock-swap transaction between two publicly traded corporations is justified by the shared belief of the boards of the constituent corporations that the shareholders of their respective corporations will be better off, in the long term, as stockholders of the resulting corporation.<sup>91</sup> If not, there would be no reason to enter into the transaction. To reach this conclusion, each board must have reason to believe that the long-term prospects of the combined entity are more promising than those of their respective corporations as stand-alone entities. Thus, a stock-swap transaction can be viewed as a tool by which to accomplish a long-term business plan.<sup>92</sup>

To allow boards to pursue such long-term plans, courts have held that a stock-swap between equals does not impose *Revlon* duties on the boards of the constituent corporations.<sup>93</sup> Chancellor Allen first established this point in *Time-Warner*.<sup>94</sup> Paramount had argued that Time's board was subject to *Revlon*'s short-term, value-maximizing imperative because it approved a stock-swap merger with Warner.<sup>95</sup> Paramount argued that this imperative required Time's board to compare the estimated present value of the proposed Time-Warner transaction against the cash value of

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in the merged company).

90. See, e.g., *QVC*, 34 A.2d 637 (Del. 1994). In that case, the challenged transaction, a business combination between Viacom and Paramount, began as a stock-swap merger and was restructured into a tender offer by Viacom for Paramount stock to be followed by a squeeze out merger. The restructuring was in response to a competitive bid for Paramount by QVC. Both forms of the challenged transaction, merger and two-step process were intended to achieve the same result—the combination of the business of Viacom and Paramount.

91. See, e.g., *Time-Warner*, 571 A.2d at 1150 (“[The Board has the] authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of ‘long-term’ versus ‘short-term’ values is largely irrelevant . . .”).

92. *Id.* at 1151-52.

93. *Santa Fe*, 669 A.2d at 71.

94. *Paramount Commc'ns, Inc. v. Time, Inc.*, Nos. 10866, 10670, and 10935, 1989 WL 79880, at \*22 (Del. Ch. July 14, 1989).

95. *Id.* at \*21.

Paramount's tender offer, and abandon the proposed merger if it was worth less than Paramount's tender offer.<sup>96</sup>

The Chancellor rejected this argument because the stock-swap merger would not result in a change of control.<sup>97</sup> The stock of each company was publicly traded, and the majority of the shares of each company were held by disaggregated public stockholders. Accordingly, voting control of each company was in the public markets.<sup>98</sup> The stock of the resulting corporation would also be publicly traded, and control would remain in the hands of disaggregated public stockholders.<sup>99</sup> Accordingly, the merger would not result in a change of control, and the transaction would not command the payment of a control premium.<sup>100</sup> The Chancellor reasoned that, where a transaction did not create an opportunity to negotiate for a control premium, *Revlon* was inapplicable, and the focus of the board's fiduciary duties remained on the long-term corporate benefit to be achieved by the merger. Thus, according to the Chancellor, so long as the stockholders will have on-going equity participation *and* control remains in the public markets, the board may continue to pursue its long-term vision for the company.<sup>101</sup>

*b. Sale of Control*

In *Paramount Communications Inc. v. QVC Network, Inc.*,<sup>102</sup> the Delaware Supreme Court examined the other side of this proposition. The challenged transaction would have combined Viacom and Paramount into a publicly-held corporation in which Viacom's majority stockholder would

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96. *Id.*

97. *Id.* at \*23.

98. *Id.*

99. *Id.* The original Time-Warner merger did not involve a change of control. Before the merger, control of Time "existed in a fluid aggregation of unaffiliated shareholders representing a voting majority—in other words, in the market," and after the merger, control of the resulting entity, Time-Warner, would remain in the market. *Time-Warner*, 571 A.2d at 1150 (quoting Paramount 1989 WL 79880, at \*21). The resulting corporation would be bigger and have more stockholders, but public stockholders would retain control. In a merger of publicly traded equals, the merger consideration need not include a control premium because, in such a transaction, control has not been transferred to a new owner. It remains with the publicly traded shares of the resulting corporation. The stockholders still have the opportunity to obtain a control premium for their shares in the event someone seeks to acquire control of the resulting company. *Id.* at 1151.

100. A control premium is the amount above a corporation's going-concern value that an acquirer will pay to be able to exercise control over the corporation.

101. The Delaware Supreme Court reached the same conclusion when it considered the case on appeal. It stated: "Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy." *Time-Warner*, 571 A.2d at 1154.

102. 637 A.2d 34 (Del. 1994).

hold a majority of the resulting stock.<sup>103</sup>

The transaction was originally structured as a merger in which the stockholders of Paramount would receive cash plus a mix of Viacom debt and equity securities in consideration for their cancelled Paramount shares.<sup>104</sup> When the deal was announced, QVC made a higher priced all cash tender offer for Paramount.<sup>105</sup> To block QVC, Viacom and Paramount modified their merger agreement to provide for a two-step transaction in which Viacom would make an all cash tender offer for enough Paramount shares to give it 51% of Paramount's stock and then effectuate a squeeze-out merger to cancel the remaining 49% of Paramount's shares in exchange for a mix of Viacom equity and debt securities.<sup>106</sup> At the end of the process, Paramount's stockholders would have received a mix of cash, debt securities and shares of the combined enterprise. However, their shares would constitute a minority of the voting power.<sup>107</sup> Sumner Redstone, the majority stockholder of Viacom, would hold the majority of the votes in the combined entity.<sup>108</sup>

Paramount and Viacom argued that the agreement did not invoke *Revlon* duties because the Paramount stockholders would have on-going equity participation in the newly created enterprise. The court rejected this argument because Paramount's public stockholders would end up holding a minority of the votes in the combined corporation.<sup>109</sup> The court explained that the transaction amounted to a sale of control by Paramount's stockholders because, as stockholders of the resulting corporation, they would no longer be able to form a majority voting block.<sup>110</sup> Such a transaction demanded that the consideration to be paid to the shareholders who would end up as minority shareholders of the resulting corporation should include a control premium which reflected not only the value of acquiring control, but also compensation for the corresponding loss of control.<sup>111</sup> Because control can be sold only once, this transaction represented the stockholders' last opportunity to receive a control premium.<sup>112</sup>

The QVC court linked *Revlon* duties to transactions that involved a sale of control. In this context, if a third party makes an unsolicited offer to acquire the company, the board must consider the new offer because the

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103. *Id.* at 43.

104. *Id.* at 39.

105. *Id.* at 39-40.

106. *Id.* at 40.

107. *Id.* at 43.

108. *QVC*, 637 A.2d at 43.

109. *Id.*

110. *Id.* at 42-43.

111. *Id.* at 43.

112. *Id.*

board's primary objective is to get the best deal for the stockholders.<sup>113</sup> Thus, the board cannot pursue the long-term plans that justify the stock-swap merger when an alternative proposal offers the stockholders' greater value. The court said: "Where stock or other non-cash consideration is involved, the board should try to quantify its value, if feasible, to achieve an objective comparison of the alternatives . . . . [Then,] the directors must decide which alternative is most likely to offer the best value reasonably available to the stockholders."<sup>114</sup>

*c. Sale of Control Should Be Irrelevant to Duty-Shifting*

QVC achieved the right result, but for the wrong reason. The court correctly concluded that the board of Paramount had an obligation to compare the value of QVC's intervening bid against the value of the pending Viacom deal, but that duty did not arise because the Viacom deal involved a change of control that would justify a control premium. A control premium is merely an element of value. Its availability does not provide a principled reason to require a board to abandon a pending business combination in favor of a more valuable offer. Nor does the non-availability of a control premium provide a principled reason to allow a board to pursue a less valuable transaction when a more valuable transaction is available. Quite simply, the availability or non-availability of a control premium is irrelevant to determining whether the board is subject to *Revlon* duties.

The issue of whether a board is subject to *Revlon* duties is commonly presented when a third party makes an apparently higher bid for the corporation before a pending transaction has closed. In this context, the board's duty to consider whether the subsequent offer would be more valuable to stockholders derives from the fact that the nature of the pending transaction has put the board in a position where it is acting as an agent for the corporation's stockholders. All agents owe their principals a duty of loyalty. In the context of a transaction that involves the conversion of the stockholders' shares into shares of another corporation, that duty of loyalty requires the board to seek to maximize the consideration the stockholders will receive for their shares. If another bidder makes an offer to acquire the corporation, the board's duty to stockholders requires it to determine whether the new bid will allow the stockholders to receive greater value for their shares than the pending offer.<sup>115</sup>

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113. *Id.* at 44.

114. *QVC*, 637 A.2d at 44-45.

115. *See ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 110-11 (Del. Ch. 1999) (holding unenforceable a lock-up provision which did not allow a target company to consider unsolicited bids).

The difficulty arises when the board must make a decision between a new bidder who offers an arguably higher price and a pending stock-swap transaction that is intended to effectuate a long-term business plan. The pending merger will serve the long-term prospects of the enterprise, but the intervening offer arguably promises greater value to the stockholders, the owners of the enterprise. The board's duty to the corporation conflicts with its duty to the stockholders. The Delaware courts, following the reasoning in Chancellor Allen's *Time-Warner* decision, have used the concept of "change of control" to determine which duty predominates. Under current Delaware law, in a non-control-shifting, stock-swap transaction, the board does not have a duty to maximize the immediate value of the stockholders' shares because the stock-swap was motivated by a long-term business plan and will not result in a change of control.

The different treatment of control-shifting and non-control-shifting stock-swap transactions makes little sense. Both transactions involve ownership decisions because both will convert the stockholders' shares of their corporation's stock into shares of the resulting corporation. The fact that control remains in the market may justify the omission of a control premium as an element of consideration for which the board has a duty to negotiate,<sup>116</sup> but it does not explain why the board, which has initiated an ownership transaction in which it must function as the stockholders' agent, can sacrifice the best interests of its principals (the stockholders) to pursue a long-term business plan for the benefit of the corporation. Indeed, the Delaware Supreme Court previously held that the board cannot consider the interests of other corporate constituencies (who are the ones served by a long-term business plan) unless the board can show that doing so would enhance shareholder value.<sup>117</sup>

When the board undertakes a transaction that presents ownership issues, it takes on a duty to the stockholders. That duty prevents the board from sacrificing the shareholders' best interests by locking them into a transaction that fulfills a long-term corporate plan when an alternative transaction offers them greater value.<sup>118</sup> This is true for control-shifting

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116. In a stock-swap merger of equals, there is no need for a control premium. The exchange ratio merely needs to fairly reflect the respective values of the constituent corporations. But, in a control-shifting stock-swap merger, the exchange ratio should also include a control premium to compensate the shareholders for the control that they are giving up.

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

118. From the view point of the shareholders on behalf of whom the board is negotiating, a control-shifting transaction and a non-control-shifting transaction differ only in degree, not in kind. In both, the board must justify the transaction on the basis that it will be more valuable in the long-term for its stockholders who will be on-going equity participants in the resulting business combination. And in both, the stockholders of the constituent corporations will lose voting power because their shares will be converted into shares of the

and non-control-shifting transactions alike. The board must compare the present value of the business plans of the proposed business combination to the immediate value of the third party's offer. If the immediate value of the third party's offer is greater than the present value of the proposed business combination, the board's *Revlon* duty prevents it from going forward with the less valuable business combination.

The Court of Chancery recognized this on-going duty in *ACE Limited v. Capital Re Corp.*<sup>119</sup> There, the court addressed the question of whether, in the context of a non-control-shifting, stock-swap merger, a corporation's merger partner could enforce deal protection measures that would prevent the corporation's board from abandoning the merger in favor of a higher priced offer presented by a third party after the agreement had been signed but before it had closed. Capital Re had agreed to be acquired by ACE pursuant to a stock-for-stock merger.<sup>120</sup> Then, XL Capital, Ltd. made a higher priced, all cash tender offer for all of Capital Re's shares.<sup>121</sup> Capital Re's board determined that the XL offer was superior to ACE's and sought to terminate the merger agreement with ACE so that its stockholders could accept XL's tender offer.<sup>122</sup> The court recognized that even though the stock-swap merger did not implicate *Revlon* duties, the board had an ongoing duty to stockholders that required it to act in their best interests.<sup>123</sup> The merger had not closed, so the transaction had not reached a point where ACE's investment and expectations in the deal were so substantial that it would be unfair for ACE's contractual rights to give way to the interest of Capital Re's stockholders.<sup>124</sup> In reaching this result, the court rejected ACE's argument that *Time-Warner* and *QVC* permitted a board to pursue a less valuable stock-swap merger as part of a long-term business

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combined business entity, a larger company with a larger body of stockholders. The difference lies only in the degree of voting power they will lose. In a control-shifting transaction, the unaffiliated stockholders' will see their voting power drop from 100% to minority status. In a non-control-shifting transaction, their voting power will be diminished from 100% to a percentage that reflects their corporations' contribution to the combined business entity. In both cases, the individual stockholders will experience a loss of voting power.

119. 747 A.2d 95, 110-11 (Del. Ch. 1999).

120. *Id.* at 97.

121. *Id.* at 99.

122. *Id.* at 100.

123. *Id.* at 104-05.

124. Delaware has given primacy to the interest of stockholders in being free to maximize value from their ownership of stock without improper compulsion from executory contracts entered into by boards. *Id.*; see also Paul L. Regan, *Great Expectations? A Contract Law Analysis for Preclusive Corporate Lock-Ups*, 21 *CARDOZO L. REV.* 1, 6 (1999) ("Historically, the judicial impulse in cases challenging the validity of break-up fees, lock-ups, and no-shops amidst a proposed change of control transaction has been to protect the interests of the target corporation's stockholders . . . from potential lapses in fidelity by their duly elected directors . . .").

plan even when an intervening cash offer would allow the stockholders to receive greater value for their shares.<sup>125</sup>

*ACE* and *Time-Warner* have one thing in common: in both, the court agreed with the board's decision. However, that is the only commonality. The challenged board decisions in the two cases were opposite. In *ACE*, the board sought to be released from the pending transaction so that it could pursue the intervening transaction. In *Time-Warner*, the board sought to uphold the pending transaction so that it could reject the intervening transaction. *Time-Warner* got it wrong. Its reliance on the board's prerogative to adopt long-term business plans for a corporation ignored the fact that the transaction in issue required the board to function as the stockholders' agent. *ACE* recognized that the board's duty to the stockholders required it to abandon long-term plans when a better deal became available.

#### D. Conclusion

The determination of whether the board's fiduciary duties should be directed toward serving the long-term welfare of the corporation or short-term maximization of the value of the corporation's shares turns on whether the nature of the transaction under consideration requires the board to function as an agent for the stockholders. If the board is functioning as an agent for the stockholders, it must serve their best interests. It can only pursue long-term corporate interests if the pursuit of those interests also serves the stockholders' best interests.<sup>126</sup>

The stockholders become the principal beneficiaries of the board's fiduciary duties when the board considers a transaction that will alter their ownership interest in the corporation. This includes cash-for-stock transactions that will terminate the stockholders' equity participation in the enterprise and stock-for-stock transactions in which the stockholders will have on-going equity participation in the resulting business combination. A transaction that will terminate the stockholders' ownership of the company represents the last opportunity for stockholders to profit from their investment in the corporation. In this circumstance, the board's fiduciary duties are focused on the objective of maximizing the immediate value for stockholders. In a stock-swap transaction, the board must be satisfied that their company's stockholders will be better off, over the long-term, as stockholders of the resulting business combination.<sup>127</sup> If it were

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125. *Capital Re*, 747 A.2d at 107-08.

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

127. The board must also make sure that the exchange ratio reflects its corporation's contribution to the resulting business combination. Change of control is relevant to determining how much consideration should be paid to the shareholders who are losing

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not so, there would be no reason to pursue the merger. However, this long-term component does not change the fact that the board is functioning as an agent for the stockholders.

As the stockholders' agent, the board has a duty to make sure the transaction will allow the stockholders to receive the highest reasonable value for their shares. The board also has an ongoing duty to consider any alternative proposal presented before the pending transaction closes. The board's duty to the stockholders would prevent it from pursuing the pending transaction as part of a long-term business plan if an intervening transaction offered greater value to the stockholders (who are, after all, said to be the owners of the corporation, and whose property, the shares of the corporation's stock, will be converted into shares of the resulting corporation's stock). The board does not have to accept the third party's offer.<sup>128</sup> It retains the power to abandon the pending deal and remove the corporation from the deal market.<sup>129</sup> But, the board does not have the power to force an inferior deal on the corporation's stockholders.

### III. THE BUSINESS JUDGMENT RULE

When a stockholder brings a claim challenging a transaction approved by his company's board of directors there are two possible areas of inquiry. The first is legal in nature and asks whether the directors complied with their fiduciary duties in making the challenged decision. The second looks to the merits of the decision and asks whether it will serve the corporation's best interests.

The second area of inquiry, standing alone, does not provide a valid basis for a claim against the directors. Business decisions require the board to make judgments about the future. The future is never certain. There is always a probability that events will turn out differently than planned. It follows that a carefully made decision motivated by a good faith belief that it will serve the corporation's best interests may turn out badly and leave the corporation in worse shape than it would have been in had the decision not been made. There is always risk of failure, and the pursuit of profit requires corporations to take calculated business risks.

The business judgment rule allows boards to take calculated business risks without fear of incurring personal liability if things turn out badly. It accomplishes this by preventing courts from reviewing the substantive merits of business decisions made in good faith by independent and disinterested directors. To successfully challenge a board decision, a

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control.

128. *Pogostine v. Rice*, 480 A.2d 619, 627 (Del. 1984)

129. *Gantler v. Stephens*, No. 2392-VCP, 2008 WL 401124, at \*8 (Del. Ch. Feb. 14, 2008).

plaintiff must prove that the decision was made in violation of the directors' fiduciary duties. The business judgment rule establishes the procedure by which Delaware's judiciary reviews the directors' performance of their fiduciary duty.<sup>130</sup>

A. *The Presumption of Judicial Deference*

The business judgment rule functions as a procedural rule and as a substantive rule of law.<sup>131</sup> On the procedural level, the business judgment rule begins with the presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company."<sup>132</sup> In other words, the rule presumes that the directors have complied with their fiduciary duties of care and loyalty.<sup>133</sup> The rule requires the plaintiff to rebut this presumption by showing<sup>134</sup> facts that give reason to doubt the directors' performance of these duties.<sup>135</sup> If the plaintiff fails to produce such evidence, the presumption that the directors acted with care and loyalty stands un-rebutted.

At this point the "substantive" aspect of the rule comes into play. The business judgment rule provides that "a decision made by a loyal and informed board will not be overturned by the courts . . . ."<sup>136</sup> In other words, the court will not examine the merits of the directors' decision in the absence of facts showing a breach of the duty of care or suggesting a

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130. See *In re Citigroup S'holder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009), in which the plaintiffs sought to hold Citigroup's directors liable for losses sustained by the corporation in the sub-prime mortgage market. The court rejected the plaintiffs' claims, explaining: "[P]laintiff shareholders [are] attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company. Delaware Courts have faced these types of claims many times and have developed doctrines to deal with them - the fiduciary duty of care and the business judgment rule. These doctrines properly focus on the decision-making process rather than on a substantive evaluation of the merits of the decision. This follows from the inadequacy of the Court, due in part to a concept known as hindsight bias,[footnote omitted] to properly evaluate whether corporate decision-makers made a 'right' or 'wrong' decision." 964 A.2d at 124.

131. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993).

132. *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

133. *Orman*, 794 A.2d at 19-20; *Aronson*, 473 A.2d at 811-12; *Cede*, 634 A.2d at 361.

134. "Showing" is used here to embrace both the plaintiff's burden of *pleading* such facts in the complaint and *proving* such facts at trial.

135. *Cede*, 634 A.2d at 361; *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995).

136. *Cede*, 634 A.2d at 361. The court quotes *Sinclair Oil Corp.* to the effect that the court can overturn a decision if "it cannot be 'attributed to any rational business purpose.'" *Id.*

possible breach of the duty of loyalty.<sup>137</sup> This substantive component of the business judgment rule requires judges to defer to a business judgment made by impartial and careful directors provided the decision is not completely irrational.<sup>138</sup> It is this principle of judicial deference that protects impartial and careful directors from personal liability for a decision made with due care and with a good faith belief that it would serve the best interests of the corporation, even if the decision turns out to have been a bad one.<sup>139</sup>

### B. *Review of Fiduciary Duties*

The business judgment rule places the burden on the plaintiff to rebut the presumption that the directors acted in accordance with their fiduciary duties. The plaintiff can do this in two ways: it may show facts that place the director's duty of loyalty in issue;<sup>140</sup> or it may show facts that show a breach of the duty of care.<sup>141</sup>

#### 1. Duty of Loyalty

The duty of loyalty requires a director "affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it . . . ."<sup>142</sup> The director's decisions must be made with a good faith belief that the course of action they are choosing will serve the best interests of the corporation.<sup>143</sup> "Essentially, the duty of loyalty mandates that the best interest of the corporation and its shareholders takes

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137. The Delaware courts will not "second-guess" decisions made by disinterested and independent directors. *Cede*, 634 A.2d. at 361; *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989); *Van Gorkom*, 488 A.2d at 872.

138. E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 393-94 (1997); David Rosenberg, *Galactic Stupidity and the Business Judgment Rule*, 32 J. CORP. L. 301, 301-02 (2006).

139. The court "should decline to evaluate the wisdom and merits of a business decision" made with due care by a board which is independent and disinterested. *MacMillan II*, 559 A.2d at 1279.

140. *See, e.g.*, *Heineman v. Datapoint Corp.*, 611 A.2d 950, 954-55 (Del. 1992) (finding the presumptions of the business judgment rule were rebutted where duty of loyalty issues were raised by allegations showing that directors had diverted corporate assets to their private use and by allegations that directors were under the domination and control of an individual who owned a company that benefited from its dealings with the corporation).

141. *See Van Gorkom*, 488 A.2d at 864-71 (outlining the classic example of a breach of the duty of care).

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

143. *Id.*

precedence over any interest possessed by a director . . . .”<sup>144</sup>

The business judgment rule’s presumption that a director acted consistently with his duty of loyalty may be rebutted by facts that suggest that the director was not in a position to make an impartial assessment of the corporation’s best interests. Classically, two fact patterns place a director’s impartiality in issue. The first involves a director who has a direct, or indirect, interest in the pending decision that conflicts with those of the corporation.<sup>145</sup> The second involves a director who is under the influence of a person whose interests in the transaction conflict with those of the corporation.<sup>146</sup> Both situations compromise the director’s impartiality.

The existence of facts that establish a director’s lack of impartiality, standing alone, are not sufficient to prove a breach of the director’s duty of loyalty.<sup>147</sup> The compromised director may have subordinated his self-interest and approved the challenge decision with a good faith belief that it would serve the best interest of the corporation. In that circumstance, the duty of loyalty is still served.<sup>148</sup> But, the existence of facts that place the director’s impartiality in doubt are enough to require the compromised director to prove that his or her decision was intended to serve the corporation’s best interests. Accordingly, the business judgment rule imposes a burden of proof on compromised directors that requires them to prove that the challenged transaction is “entirely fair” to the corporation.

## 2. Duty of Care

The duty of care requires directors, individually and collectively, to “inform[] themselves, ‘prior to making a business decision, of all material

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144. *Id.*

145. This would be the case where the director stands on both sides of the transaction, *Nixon v. Blackwell*, 626 A.2d 1366, 1374 (Del. 1993), or where the director has a financial interest in the party on the other side of the corporation. Even in an arms-length transaction, a director may have a material self-interest that will compromise his objectivity. *Cede*, 634 A.2d. at 362.

146. This is where directors are employed by the other party. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (holding that the presence of officers and directors of the majority stockholder on the board of the subsidiary corporation raised duty of loyalty issues regarding the subsidiary board’s approval of a merger between parent and subsidiary); *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 102 (1952) (noting that officers and directors of majority stockholder who constituted a majority of the subsidiary corporation’s board were “on both sides of the transaction” which implicated the entire fairness standard of review). *But see* *Heineman v. Datapoint Corp.*, 611 A.2d 950, 955 (Del. 1992) (involving directors beholden to an interested party).

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

148. It is no violation of the duty of loyalty to place the best interest of the corporation ahead of one’s own self-interest.

information reasonably available to them”<sup>149</sup> and to act with requisite care in deliberating on the decision.<sup>150</sup> This requires directors to take an active and direct role in the decision-making process.<sup>151</sup> But, mere negligence is not enough to establish a violation of the duty of care.<sup>152</sup> To establish an actionable breach of the duty of care, the plaintiff must show that the director acted with gross negligence.<sup>153</sup>

Evidence regarding a breach of the duty of care is different than evidence regarding a breach of the duty of loyalty. Proof that a director is not in a position to make an impartial judgment does not, standing alone, establish a breach of the duty of loyalty.<sup>154</sup> But, proof that a director acted with gross negligence is enough, standing alone, to establish a breach of the duty of care.<sup>155</sup> What remains is to establish that this lack of care caused damage to the corporation or its stockholders.<sup>156</sup> In the tort context, the burden is on the plaintiff to prove that damages were proximately caused by the defendant’s negligence. But, in the fiduciary duty context, the plaintiff is relieved of this burden.<sup>157</sup> Instead, the grossly negligent directors must prove that the decision was entirely fair to the corporation, despite their lack of diligence.

### C. *Review of the Merits: Entire Fairness*

Once the plaintiff has shown that the directors’ impartiality is compromised or that the challenged transaction was tainted by a breach of the duty of care, the business judgment rule shifts the burden of proof to the directors and requires them to demonstrate that the challenged transaction was “entirely fair” to the corporation.

If the entire fairness analysis was triggered by a showing that the

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149. *Van Gorkom*, 488 A.2d at 872 (quoting *Aronson*, 473 A.2d at 812).

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

151. *Citron*, 569 A.2d at 66.

152. *Van Gorkom*, 488 A.2d at 873.

153. *Id.* at 875. Of course, there are few instances in which courts hold directors personally liable for damages resulting from breach of the duty of care. *Van Gorkom* is noteworthy because it was so unusual. Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 490 (2000). Moreover, most corporations have 102(b)(7) provisions in the certificates of incorporation that protect their directors from personal liability for breach of the duty of care. 8 Del. C. § 102(b)(7). However, breach of the duty of care remains important in claims seeking injunctive relief and other equitable remedies that do not involve the imposition of financial damages on the directors.

154. However, it is sufficient to require the director to prove that the challenged decision was entirely fair to the corporation, and thus that it was consistent with his obligation to serve the corporation’s best interests.

155. *Cede*, 634 A.2d. at 367; *Van Gorkom*, 488 A.2d at 872.

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

157. *Id.*

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directors lacked impartiality, a finding that the transaction was entirely fair to the corporation will support the conclusion that the compromised directors did, in fact, satisfy their duty to serve the corporation's best interests. In this circumstance there has been no breach of the duty of loyalty and no remedy is required. But, if the court concludes that the transaction was not entirely fair to the corporation the court will infer that the dubious directors were motivated by self-interest rather than the best interests of the corporation. In this circumstance there has been a breach of the duty of loyalty and the transaction will be enjoined or the directors will be held personally liable to the corporation for damages caused by their breach of fiduciary duty.

If the entire fairness analysis was triggered by a showing that the directors were grossly negligent, the analysis is slightly different. The business judgment rule requires the grossly negligent directors to prove that, notwithstanding their lack of care, the transaction was "entirely fair" to the corporation. If the directors can prove this, it follows that breach of the duty of care did not harm the corporation. As a consequence the court will not award a remedy. But, if the transaction was not entirely fair, it will be enjoined or the directors will be held personally liable to the corporation for damages caused by their gross negligence.

#### *D. Conclusion*

The business judgment rule functions like an "on/off" switch. If the plaintiff cannot call the loyalty of a majority of the directors who approved a challenged transaction into question by showing that they were subject to conflicting interests or were under the influence of a person with conflicting interests, or if the plaintiff cannot prove that a majority of the directors breached their duty of care, the court will not review the merits of the decision. Instead, it will defer to the business judgment of the corporation's disinterested, independent, and careful directors. But where the plaintiff can establish reason to doubt the loyalty or the diligence of the directors, the rule requires the dubious directors to prove that the challenged transaction was entirely fair. In other words, in the absence of a breach of fiduciary duty, the court will not examine the substantive merits of the challenged decision, but in the presence of such a breach, it will look at the substantive merits to make sure the challenged transaction was entirely fair to the corporation.<sup>158</sup>

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158. The substantive and procedural aspects of the business judgment rule correlate to the substantive and procedural aspects of the challenged decision making. Procedurally, the burden is on the plaintiff to show that the procedure by which the challenged decision was made was somehow defective. This defect may derive from the fact that the decision-makers lacked objectivity or the fact that the decision-makers were grossly negligent. If so,

## IV. ENHANCED SCRUTINY

The business judgment rule's requirement of judicial deference to a decision made by impartial and careful directors proved unsatisfactory when the courts were called upon to consider transactions designed to fend off unsolicited takeover bids. Complete judicial deference seemed to give the board too much latitude in a situation in which the decision to thwart a takeover bid might have been motivated by the directors' desire to retain the benefits of corporate office rather than the best interests of the corporation and its stockholders. On the other hand, the entire fairness standard was inapposite because these defensive transactions were approved by independent, disinterested, and careful directors. And, even if the directors' possible interest in retaining their corporate positions were deemed to compromise their impartiality, the entire fairness standard did not quite work because the transactions were accomplished under terms that were entirely fair to the corporation.

The real issue in these cases was the boards' good faith. The fact that the defense of the corporation also had the effect of defending the directors' jobs raised a question: Were the directors motivated by a good faith belief that the company was in danger, as they claimed, or were they actually motivated by a desire to save their jobs?<sup>159</sup> Plaintiffs argued that the directors' sole or primary purpose was to entrench themselves in office.<sup>160</sup> This argument made some sense when a majority of the directors who approved the defensive transaction were also senior officers of the corporation. Their positions as corporate officers represented their primary source of income which provided a powerful motive for entrenchment. But, when a majority of the directors were not employed by the corporation, the entrenchment motive fit less well.<sup>161</sup> They were not

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the court will then examine the substance of the decision. In other words, the court's first level of inquiry is to look at the procedure by which the challenged decision was made. In the absence of a procedural problem it will not examine the substantive merits of the decision. Or if the procedure was deficient (either because the people that made it lacked objectivity or were grossly negligent) then the decision-makers must prove that the decision did in fact serve the best interest of the corporation. That is, that the decision was entirely fair to the corporation.

159. The court recognized that if it allowed the business judgment rule to apply to these kinds of transactions, it would amount to a license to every board in the country to simply take defensive measures against all takeovers. Such a rule would give boards too much power. On the other hand, if all of these transactions were subjected to the entire fairness standard, it would impose too great a burden on boards seeking to establish the fairness of the defensive measures adopted by the boards. What was needed, and what the *Unocal* decision sought to provide, was a middle ground.

160. *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 438-39 (Del. 1971); *Petty v. Penntech Papers, Inc.*, 347 A.2d 140, 143 (Del. Ch. 1975).

161. An outside director's interest in the fees he or she is paid for services is not

protecting a job that represented their primary income. And, if the courts were to consider the preservation of a directorship as a sufficient motive to support a claim of entrenchment, then all defensive actions would be automatically deemed self-interested and thus subject to judicial review under the entire fairness standard. That would have been too broad a brush, since corporations needed to be able to defend against hostile takeovers that posed a legitimate threat to the corporation or its stockholders.

Because both motives (defense of the corporation and retention of corporate office) could reasonably be inferred from the decision to take corporate action designed to block a takeover, the courts required the directors whose motives were in doubt to rebut the inference that they were motivated by an improper purpose by proving that the defense was intended to serve a valid corporate purpose.<sup>162</sup> If a valid corporate purpose was present, the courts presumed that the corporate purpose was the primary motive. The directors having thus neutralized the inference that their actions were motivated by an improper purpose, the courts would defer to the directors' decision to block the threatened takeover.

#### A. *Unocal: Enhanced Scrutiny of Defensive Transactions*

This approach was crystallized in the famous *Unocal v. Mesa Petroleum* decision.<sup>163</sup> In *Unocal*, Mesa Petroleum launched a two-step takeover bid to takeover Unocal Corporation.<sup>164</sup> The first step was a tender offer for thirty-seven percent of Unocal's outstanding shares, an amount which taken together with Mesa's existing holdings of slightly more than thirteen percent, would give Mesa voting control of Unocal.<sup>165</sup> Mesa's offering price was fifty-four dollars per share, a modest premium over Unocal's pre-offer trading price of forty-six dollars.<sup>166</sup> The second step was a squeeze-out merger in which the remaining Unocal shareholders would receive highly subordinated debt instruments with a face value of fifty-four dollars per share, but an actual value that would likely be

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considered sufficient to compromise his or her independence. *Grobow v. Perot*, 539 A.2d 180, 188 (Del. 1988).

162. The business judgment rule applies to defensive maneuvers. The cases hold that a selective repurchase of the dissident's stock is a valid means of eliminating the perceived harm from a threatened takeover. *Cheff v. Mathes*, 199 A.2d 548, 554 (Del. 1964); *Kors v. Carey*, 158 A.2d 136, 141 (Del. Ch. 1960); *Kaplan v. Goldsamt*, 380 A.2d 556, 568-69 (Del. Ch. 1977); *see also Veasey, supra* note 134, at 398 (explaining that, under Delaware law, plaintiffs bear the ultimate burden of persuasion to show that directors exercising defensive measures have acted unreasonably if they believed in good faith that a threat to the corporation existed and the response to the threat was proportional).

163. *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946 (Del. 1985).

164. *Id.* at 949.

165. *Id.*

166. *Id.*

somewhat lower.<sup>167</sup>

In an effort to block Mesa's tender offer, Unocal offered to purchase forty-nine percent of its own outstanding stock in exchange for senior Unocal debt securities to be valued at seventy-two dollars per share.<sup>168</sup> The exchange offer was extended to all Unocal shareholders except Mesa.<sup>169</sup> The exchange offer would defeat Mesa's tender offer because Unocal's stockholders would accept the more valuable exchange offer rather than Mesa's lower priced cash offer. It would also punish Mesa because Mesa's shares, which were excluded, would be devalued when the exchange offer closed. Mesa responded by seeking, and obtaining, a preliminary injunction against Unocal's exchange offer.<sup>170</sup> On appeal, the Delaware Supreme Court was called upon to define the standard by which it would review the board's decision to approve the defensive exchange offer.<sup>171</sup> Unocal, pointing to the uncontested fact that a majority of its directors were independent and disinterested and had exercised due care, argued that their decision to approve the exchange offer was entitled to judicial deference under the business judgment rule.<sup>172</sup> Mesa, on the other hand, argued that the exchange offer should be reviewed under the entire fairness standard because its exclusion of Mesa violated the board's duty to treat all stockholders equally.<sup>173</sup>

The court rejected both arguments and fashioned a new, intermediate standard of review<sup>174</sup> that would allow the court to examine the board's

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167. *Id.* at 949-50.

168. *Id.* at 951.

169. *Id.*

170. *Id.*

171. *Id.* at 953.

172. *Id.* The decision to implement these various defensive measures was taken by an independent and disinterested board, the vast majority of whom were outsiders. The board acted quickly, but with great diligence. It was advised by independent financial advisors and by independent outside council. In short, under the business judgment rule, the court had no ground on which it would be able to review the substance of the board's decisions challenged by the plaintiff's complaint.

173. *Id.* The entire fairness standard of review is not well suited to analyzing the challenged transaction in *Unocal*. That concept is useful in determining whether or not the corporation got the benefit of the bargain when a fiduciary is on both sides of the table or is beholden to the party across the table. In *Unocal*, however, the decision did not involve the fairness of the transaction. Rather, it involved the fairness of excluding a hostile bidder from the exchange offer that was intended to block the hostile bidder's tender offer. The company was not a party to the tender offer. And, there was no argument that the exchange offer was not at a fair price. The real issue was whether the board had a right and a sufficient reason to interpose a defense against Mesa's offer.

174. EDWARD P. WELCH ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW: FUNDAMENTALS* § 141.2.4.1 (2009 ed.). If Mesa had been able to prove facts that would rebut the presumptions of the business judgment rule, the court would subject the challenged transaction to "strict scrutiny" required under the "entire fairness" standard, the most rigorous standard of review under Delaware law. *See, e.g., MacMillan II*, 559 A.2d at 1279

reasons for approving the defensive transaction. The court explained: “Because of the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.”<sup>175</sup> This judicial examination came to be known as “enhanced scrutiny.”

On a substantive level, *Unocal* presented two issues: (1) whether a corporation had a right to interfere with a tender offer extended to its stockholders by a third-party;<sup>176</sup> and (2) whether Unocal’s board had breached its fiduciary duty to Mesa, a stockholder, by excluding it from participation in the exchange offer.<sup>177</sup> In deciding the first issue, the court held that a board had “a fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived.”<sup>178</sup> Regarding the second issue, the court held that Mesa’s exclusionary exchange offer was a reasonable response to the threats posed by Mesa’s tender offer.<sup>179</sup>

These two points solidified into what has come to be known as the two-prong “*Unocal* standard.” The first prong requires the directors who approved the defensive action to prove that their decision was based on a reasonable belief that the takeover bid posed a threat to the corporation or its stockholders.<sup>180</sup> In other words, the directors have the burden of proving facts that neutralize the possible inference that they were actually protecting their jobs rather than the corporation or its stockholders.<sup>181</sup> The second prong requires the directors to prove that their defensive response was “reasonable in relation to the threat posed.”<sup>182</sup> This requires the court

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(applying the entire fairness standard).

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

176. The corporation is not a party to the tender offer and thus it arguably had no right to interfere with the offer extended by the third party directly to the stockholders.

177. *Unocal*, 493 A.2d at 953.

178. *Id.* at 954. In *Unocal*, the offer threatened stockholders in two prominent ways. First, it was undervalued. *Id.* The board estimated Unocal to be worth much more than the fifty-four dollars per share offered by Mesa. *Id.* Second, it was coercive. *Id.* The two step structure meant that a financially rational shareholder would have to tender his shares into the cash tender offer, even though he believed the price was inadequate, because if he didn’t, he would be squeezed out by the second-step merger in exchange for junk bonds of dubious value. *Id.*

179. The court found that the exclusion of Mesa from the exchange offer was reasonable because what minority shareholders received under it was substantially equal in value to their holdings prior to the exchange offer. *Unocal*, 493 A.2d at 956.

180. *Id.* at 955.

181. *Id.* at 954. This proof is enhanced by a showing that a majority of the board is made up of independent outside directors: people who are less likely than highly paid corporate officers to have an entrenchment motive.

182. *Id.* at 955.

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to examine the merits of the defensive transaction to see if it is likely to accomplish its defensive purpose without achieving disproportionate results.

Importantly, *Unocal* placed the defensive transaction under enhanced scrutiny because of the need to clear away the “specter” that these apparently impartial directors might have been defending their corporate offices rather than the corporation or its stockholders. Once the directors removed this specter by establishing that they responded reasonably to a perceived threat to the corporation or the stockholders, the court gave their decision the judicial deference to which it would have ordinarily been entitled under the business judgment rule.

*B. Revlon: Enhanced Scrutiny of Sale Transactions*

In *Revlon*,<sup>183</sup> Revlon’s board responded to Pantry Pride’s unsolicited bid to takeover the company by agreeing to “sell the company” to a white knight, Forstmann-Little & Co.<sup>184</sup> Pantry Pride sought to enjoin the enforcement of certain deal protection measures in the agreement because they prevented Pantry Pride from going forward with its higher priced tender offer. Because the white knight deal was intended to defeat Pantry Pride’s unsolicited takeover bid, the court found that there was an “omnipresent specter that a board may be acting primarily in its own interests rather than those of the corporation and its shareholders.”<sup>185</sup> Accordingly, the court subjected the deal protection measures to enhanced scrutiny, the standard of review prescribed by *Unocal* for defensive transactions.<sup>186</sup>

1. Sale of the Company

Over time, the fact that *Revlon* involved a specter of entrenchment lost its significance, and the “*Revlon* doctrine” came to stand for the idea that all challenged transaction involving the sale of the company must be subject to enhanced scrutiny. The detachment of enhanced scrutiny from the “omnipresent specter” began with the court’s decisions in *MacMillan II*. There, the court held, without explanation, that all decisions made by the board in circumstances that imposed *Revlon* duties would be subject to

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183. *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986).

184. *Id.* at 183.

185. *Id.* at 180 (quoting *Unocal*, 493 A.2d at 954). Moreover, the court held that Revlon’s directors were so self-interested in the transaction that they would not be entitled to the favorable presumptions of the business judgment rule. *Revlon*, 506 A.2d at 177 n.3.

186. *Id.* at 176, 180, 184. Moreover, the court found that the directors approved the transaction for self-interested purposes. *Id.*

enhanced scrutiny. It said “[w]hen *Revlon* duties devolve upon directors, this Court will continue to exact an enhanced judicial scrutiny at the threshold, as in *Unocal*, before the normal presumptions of the business judgment rule will apply.”<sup>187</sup> Thus, a transaction involving the sale of the company would be subjected to enhanced scrutiny even though the circumstances of the transaction did not involve a “specter” that the directors might have been motivated by an improper purpose.

## 2. Sale of Control

The next step came in *QVC*. There, the court expanded the reach of so-called “*Revlon* duties” beyond a sale of the company to include a stock-swap merger that would accomplish a “sale of control.”<sup>188</sup> Having concluded that the sale of control invoked *Revlon* duties, the court, following the precedent established in *MacMillan*, reviewed the board’s decision to approve the merger under enhanced scrutiny.

Recognizing that such intensive review constituted a deviation from the business judgment rule’s policy favoring judicial deference to decisions made by disinterested, independent, and diligent directors, the court provided two justifications. First, the court relied on Delaware’s traditional practice of taking a close look at board actions that tend to impair or impede stockholder voting rights.<sup>189</sup> Second, the court relied on the idea that a sale-of-control transaction put the board in the position of selling an asset (i.e., control) that belonged to public stockholders, and for which they deserved a control premium. The court explained that “[t]here are few events that have a more significant impact on the stockholders than a sale of control or a corporate breakup. Each event represents a fundamental (and perhaps irrevocable) change in the nature of the corporate enterprise from a practical standpoint. It is the significance of each of these events . . .” that requires the court to closely scrutinize board action that could be contrary to the stockholders’ interests.<sup>190</sup>

Neither of the justifications offered by the court provides a convincing

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187. *Macmillan II*, 559 A.2d at 1288.

188. Quoting with approval from Chancellor Allen’s opinion in *Time-Warner*, the court notes that a stock-for-stock transaction where ownership of the surviving entity remains in the public markets does not constitute a change of control. Therefore, *Revlon* does not apply. *QVC*, 637 A.2d at 47. But, a stock-for-stock transaction in which a person ends up owning a controlling block of the surviving corporation’s stock will constitute a change of control and will, therefore, be governed by *Revlon*. *Id.*

189. The court ignored the fact that the cases on which it relied involved unilateral action by the board that interfered with stockholders’ ability to use their voting power. A merger, by way of distinction, requires the affirmative vote by an absolute majority of the stockholders.

190. *QVC*, 637 A.2d at 47-48.

reason to review control-shifting transactions under enhanced scrutiny. The voting cases on which the court relied all involve unilateral efforts by the board to manipulate the voting process. A merger, on the other hand, does not involve unilateral board action (it must be approved by stockholders). Further, reduction in the stockholders' voting power (for which they presumably receive a control premium) is not the result of manipulation. The fact that a control-shifting merger is important does not provide a principled reason to depart from the business judgment rule's policy that requires judicial deference to rational business decisions made by independent directors elected by the stockholders to make such decision.<sup>191</sup> The business judgment rule trusts independent directors to make important decisions in other contexts, there is no reason why they should not be trusted to approve a merger that results in a change in control.<sup>192</sup>

Moreover, neither justification explains why a control-shifting stock-swap transaction should be treated differently than a non-control-shifting stock-swap transaction. The former is subject to enhanced scrutiny; the latter is entitled to judicial deference under the business judgment rule. Yet, in both the stockholders' voting power will be diminished. They differ only in the degree of diminution. In a simple stock-swap transaction, each shareholder's voting power is diluted because the shareholder will be part of a larger group of stockholders who own shares of a larger company. The same is true of a change of control transaction; the only difference is that the public shareholders are diluted to a minority position. In both situations the board is "selling" an asset that belongs to the stockholders because it is negotiating the terms under which the shares of stock owned by the stockholders will be converted in to shares of the resulting corporation. The only difference is that the change of control transaction offers the possibility of a control premium. But, a control premium is merely another element of value, not, as the court characterizes it, a unique property right belonging to the stockholders.

### C. *The Standard for Enhanced Scrutiny*

The court's first effort to articulate a standard to guide enhanced scrutiny came in *MacMillan II*.<sup>193</sup> The court explained that enhanced scrutiny under *Revlon* would, of necessity, be slightly different from the analysis under *Unocal*.<sup>194</sup> As *MacMillan II* explained it, enhanced scrutiny

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191. Regan, *supra* note 23, at 129.

192. By definition, in a change of control transaction, the directors are unlikely to have a self-serving interest in preserving their corporate offices.

193. *MacMillan II*, 559 A.2d at 1288.

194. *Id.*

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involves a two-part test. The first issue is whether the directors properly perceived that the challenged transaction would enhance the shareholders interests. The second issue is whether the challenged transaction is reasonably likely to achieve that objective.<sup>195</sup> If the board's decision to sell the company passes this two-part test, the court would defer to the board's business judgment, or as the cases express it, the transaction will be entitled to the protections of the business judgment rule. "Once a finding has been made by a court that the directors have fulfilled their fundamental duties of care and loyalty under the forgoing standards there is no further judicial inquiry into the matter."<sup>196</sup>

This purported two-part *MacMillan* test is a little confusing. The first part seems to come down to this inquiry: Did the board reasonably believe that the challenged transaction would be of benefit to stockholders? The second seems to ask whether the transaction was related to achieving that benefit. But, this second question is, in reality, nothing more than a component of the first question. If the challenged transaction were not reasonably related to the goal of achieving a benefit for stockholders, it is hard to see how a board could reasonably believe that it would be of benefit to stockholders. For the board to reasonably believe that the challenged transaction would benefit stockholders, the transaction must be related to achieving that benefit.

In the final analysis, the Macmillan standard for enhanced scrutiny requires the court to do two things: First, it must draw inferences about the board's subjective belief by examining the information available to the board and how the board used that information during its decision making process. Second, it must examine the substantive merits of the challenged transaction to see if it would come reasonably close to accomplishing the outcome the board sought to achieve.

In *QVC*, the court rephrased the *MacMillan* test, stating that the "key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decision-making process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors action in light of the circumstances then existing."<sup>197</sup> The directors have the burden of proving both points.

This formulation of enhanced scrutiny is squarely at odds with the business judgment rule. The business judgment rule requires the plaintiff to rebut the presumption that the directors satisfied their duty of care. Enhanced scrutiny, on the other hand, requires the directors to prove that their decision was based on adequate information and was the result of an

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195. *Id.*

196. *Id.*

197. *QVC*, 637 A.2d at 45.

adequate decision-making process. In other words, the directors must prove that they complied with their duty of care. But, that is not all. The business judgment rule prevents the court from reviewing the merits of a business decision made with due care by independent directors. Enhanced scrutiny, on the other hand, requires the directors to prove that they made a “reasonable” decision.<sup>198</sup> This invitation to judicial second-guessing necessarily requires the court to consider the merits of the challenged decision.

In an apparent recognition that enhanced scrutiny represents a judicial intrusion into an area that had traditionally been the exclusive domain of directors, the court acknowledged that judicial examination of the merits of the board’s decision must be sensitive to the complexity of the transaction. The court also emphasized that the court should not substitute its view as to the best course of action for that of the board. Rather, the court should determine whether the board made a reasonable, rather than a perfect, decision. If the board’s decision is one of several reasonable alternatives, it should be approved by the court even if the judge thinks a different course of action would have been better.<sup>199</sup>

#### V. ENHANCED SCRUTINY OF CLAIMS FOR INJUNCTIVE RELIEF

Enhanced scrutiny was first applied in cases in which plaintiffs sought injunctive relief, first under *Unocal*, to review defensive actions taken in response to a threatened takeover, then under *Revlon* to review decisions to approve business combinations that would constitute a sale of the company or achieve a sale of control. In the *Revlon* context, the courts did not require plaintiffs to define whether the alleged failure to achieve the best available deal resulted from a breach of the duty of loyalty or the duty of care. Rather, the courts spoke generally of a duty to get the best price. In some cases, notably *Omnicare*, the court granted injunctive relief in the absence of any facts that would suggest a breach of either duty.<sup>200</sup>

A more precise analysis would show that *Revlon* duties involve both the duty of loyalty and the duty of care. The duty of loyalty is owed to the stockholders and requires to directors to focus their efforts on achieving a transaction that will maximize the immediate value of their shares. The duty of care requires directors to gather adequate information, follow an adequate decision-making process, and pursue a course of action that is

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198. *Id.* at n.17. The court admits this it is not applying the business judgment rule.

199. *Id.* at 46.

200. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (2002) (issuing an injunction that prevented enforcement of certain deal protection measures in a merger agreement that made shareholder approval of the merger a certainty, even though the board acted in good faith and with due care in approving the merger agreement).

reasonably likely to achieve the result defined by the duty of loyalty.

A. *Reasonableness of the Board's Decision-Making*

The standard used by the court in claims for injunctive relief to review the board's efforts to achieve the best available deal stands in stark contrast to the standard by which the court judges the duty of care under the business judgment rule.<sup>201</sup> Under the business judgment rule, the plaintiff must prove that the directors acted with "gross negligence."<sup>202</sup> But, under enhanced scrutiny the directors must prove that they followed a reasonable decision-making process. The requirement that directors follow a "reasonable" decision-making process imposes a higher standard of conduct than the business judgment rule which merely requires that directors avoid gross negligence.

Enhanced scrutiny views the duty of care in terms of reasonableness, a negligence concept. The courts explain that the directors "must act reasonably in order to secure the highest price reasonably available."<sup>203</sup> This means the directors must "take a reasonable course of action under the circumstances presented."<sup>204</sup> The court looks at the reasonableness of each decision made by the board throughout sales process. At each decision point, the court asks whether the directors' decision was within the range of decisions that would have been reasonable in the circumstance.<sup>205</sup> No single course of action is required.<sup>206</sup> "Because there can be several reasoned ways to try to maximize value, the court cannot find fault so long as the directors chose a *reasoned* course of action."<sup>207</sup> Resolution of these questions requires a fact-intensive review of the circumstances that led to the sale of the company.

The primary concern is whether the directors have followed a procedure that allows them to have enough information about the value of their corporation, the market for corporate control, and the range of potential buyers to allow them to make well informed decision that they have achieved the best available transaction for the stockholders. Directors

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201. Although the Delaware Supreme Court has not fully articulated the distinction, the Delaware courts seem to recognize a difference between claims that seek to impose personal liability on directors who approved the challenged transaction and claims that seek injunctive relief. See *Unocal*, 493 A.2d at 946 (Del. 1985) (vacating preliminary injunction requested by minority shareholder).

202. *Van Gorkom* 488 A.2d at 873 (Del. 1985).

203. *Lear*, 926 A.2d at 115.

204. *Id.*

205. *QVC*, 637 A.2d at 44.

206. *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286-87 (Del. 1989).

207. *Lear*, 926 A.2d 94 at 115 (Del. Ch. 2007).

must actively participate in the process.<sup>208</sup> Two time periods are relevant—the period before the deal is signed, and the period after it is signed, when other potential buyers may make offers to acquire the company.

### 1. Pre-Signing: The Search for the Best Deal

Where the transaction is achieved through an auction, the directors' duty of care requires them to make sure that the auction process allows all bidders to compete on a level playing field.<sup>209</sup> This means that all bidders must receive substantially equivalent information.<sup>210</sup> It also means that the board's decision to waive a bidding deadline, or to allow an additional round of bids, or not to allow an additional round of bids,<sup>211</sup> or to accept one of two substantially equivalent bids, must be fair to all bidders and be based on a carefully formed and reasonable belief that it would be in the stockholders' best interests.<sup>212</sup>

Where a transaction is not achieved by a public auction, the board must prove that the process by which the transaction was developed generated enough information to allow the board to make an informed decision that the deal was fairly priced and that a better deal was not likely. This may be accomplished by conducting a private survey of likely buyers.<sup>213</sup> But, such a survey cannot be unreasonably limited to buyers favored by management.<sup>214</sup>

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208. Kahn v. Caporella, No. 13248, 1994 WL 89016, at \*5 (Del. Ch. March 10, 1994) ("Directors who have undertaken the responsibility of selling the corporation must take an 'active and direct role' in the process." (quoting Citron v. Fairchild Camera & Instr. Corp., 569 A.2d 53, 66 (Del. 1989))).

209. *MacMillan II*, 559 A.2d at 1283; see also *In re Holly Farms Corp. S'holders Litig.*, No. 10,350, 1988 WL 143010, at \*4 (Del. Ch. Dec. 30, 1988) (finding that the board failed its *Revlon* duty to obtain the highest price for shareholders because it negotiated extensively with one of two bidders but did not make a similar effort to negotiate with the other).

210. See *MacMillan II*, 559 A.2d at 1283 (finding that the auction was skewed because one of the bidders had received a tip from someone in the boardroom). The court also found that the investment banker who was conducting the auction on behalf of the company had provided more complete information to the favored bidder and had failed to disabuse the disfavored bidder of the false impression that his was the top bid. *Id.*

211. See *In re RJR Nabisco, Inc. S'holders Litig.*, No. 10, 389, 1989 WL 7036 (Del. Ch. Jan. 31, 1989) (finding enough evidence that the board did not seek an additional round of bids because it reasonably believed that an additional round would cause one of the bidders would withdraw and leave only one remaining bidder).

212. *Id.*; see also *Gilbert v. El Paso Co.*, Nos. 7075, 7079, and 7078, 1988 WL 124325, at \*11-12 (Del. Ch. Nov. 21, 1988) (holding that the board acted reasonably in accepting a bid at a price it had previously rejected because in the intervening the board had been unable to find a higher bid).

213. *Barkan*, 567 A.2d at 1287.

214. *In re Netsmart Tech, Inc. S'holders Litig.*, 924 A.2d 171 (Del. Ch. 2007) provides an example. The independent and disinterested members of Netsmart's board approved the sale of the company after considering proposals from several private equity groups. But, the

Not all circumstances require an auction or a pre-signing market survey. Where directors have sufficient knowledge to make an informed decision regarding the fairness of the proposed transaction, they may properly agree to sell the company without conducting a pre-deal survey of the market for other potential bidders.<sup>215</sup> A decision to approve the sale of the company without having first canvassed the market can also be justified when the circumstances are such that a market survey or an auction was unnecessary<sup>216</sup> or might have diminished the value of the company.<sup>217</sup>

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board had not authorized its representatives to solicit offers from companies who were in the same or related line of business. The court faulted this decision because it believed such companies might have paid a premium price for the company because the acquisition might have given the acquirer a competitive advantage in the marketplace. The court held that the board's decision to exclude such buyers was inconsistent with its *Revlon* Duties. *Id.* at 199.

215. *In re Pennaco Energy, Inc. S'holders Litig.*, 787 A.2d 691, 706 (Del. Ch. 2001) provides an example. The directors of Pennaco approved the sale of the company after negotiating with only one bidder. The board's conduct was deemed to be less than exemplary, but it nonetheless satisfied their fiduciary duties because the company had received no other offers even though it was closely followed by financial analysts and was generally known to be open to acquisition. The board also was closely involved in the company's activities and was in a position knowledgeably evaluating the adequacy of the price. *See also In re KDI Corp. S'holders Litig.*, No. 10,278, 1988 WL 116448 (Del. Ch. Nov. 1, 1988) (not requiring a bidding contest or active market survey).

216. The sale of Lear Corporation provides an example. *Lear*, 926 A.2d at 115-16. The board of Lear approved an all-cash merger with a private equity fund headed by Carl Icahn without having publicly announced that the corporation was on the market and without having conducted a private search for potential buyers. Although the court found this process was also less than perfect (it had been negotiated by the company's CEO whose stock options would be accelerated by a sale of the company), it rejected the plaintiffs' *Revlon* claims because it found that the circumstances supported the conclusion that such procedures were unnecessary. The court found as a matter of fact that knowledgeable participants in the mergers and acquisition market would have known that a sale of the company was likely because Mr. Icahn, a person with a reputation for precipitating value-maximizing transactions, had purchased a large block of the company's shares and the company had announced that it would not use a poison pill, except in very limited circumstances.

217. The sale of Topps Co. provides an example of a circumstance in which a public offer might have harmed the company. *In re Topps S'holders Litig.*, 926 A.2d 58, 85 (Del. Ch. 2007). In *Topps*, the corporation's financial performance during the preceding five years had been poor. The company had tried, without success, to auction one of its two lines of business. An insurgent stockholder group had begun a well publicized threat to launch a proxy contest aimed at taking control and forcing a sale of the company through a public auction. Against this background, a private equity fund headed by Michael Eisner began discussions with Topps' senior managers and eventually reached an agreement by which the Eisner group would acquire the company through a merger at \$9.75 per share. The court held that Topps' decision not to conduct a pre-signing market check was reasonable because these circumstances made it obvious to participants in the financial markets that Topps needed to do a deal. *Id.* at 85. The court also held that the incumbent directors' decision not to hold a public auction was reasonable because a failed auction, on the heels of the company's failed effort to sell one of its divisions, might have diminished the value of the company. *Id.* at 84-85.

## 2. Post-Signing: Absence of a Better Deal

In a *Revlon* situation, directors have an ongoing duty to achieve the best available price for stockholders, and even in a non-change-of-control stock-swap they must remain free to deal with offers that may arise after the transaction is announced.<sup>218</sup> Accordingly, the public announcement that a company has approved a transaction governed by *Revlon* opens the door to others who wish to acquire the company and are willing to make a superior offer.<sup>219</sup> The announcement of the pending deal can also give potential bidders enough confidence in the value of the company to encourage them to make a superior offer.<sup>220</sup> Therefore, all transactions undergo what amounts to a *de facto* post-signing “market check.”

When a board faces a *Revlon* claim, it can argue that the absence of a superior bid following the announcement of the challenged agreement tends to prove that the deal approved by the board achieved the highest available price and thus satisfied the board’s *Revlon* duties.<sup>221</sup> This argument can be especially cogent when the challenged transaction is with a financial buyer and no strategic buyer, who would presumably be in a position to offer a higher price because it might be able to achieve unique economies of scale and synergies, submits a competing proposal.<sup>222</sup> This defense presents a question: Does the absence of a topping offer a reflection of the strength of the pending deal’s price or the strength of its deal protection measures?

The litigation involving Lear Corporation provides an example.<sup>223</sup> The board argued that the absence of a superior offer showed that it had achieved the best available deal. But, the merger agreement by which the

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218. *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 108 (Del. Ch. 1999).

219. *Lear*, 926 A.2d at 122. This is because the board’s fiduciary duties under *Revlon* require it to maximize stockholder value. This duty requires it to consider a superior proposal and accept a bone fide superior offer.

220. *Topps*, 926 A.2d at 87.

221. *In re Formica Corp. S’holders Litig.*, No. 10,598, 1989 WL 25812, at \*12 (Del. Ch. March 22, 1989); *In re Envirodine Indus. S’holders Litig.*, No. 10,702, 1989 WL 40792, at \*4 (Del. Ch. Apr. 20, 1989). But, the presence of deal protection measures in the merger agreement creates a question as to whether the absence of topping bids is attributable to the deal’s high price or the strength of its deal protection measures. Thus, to conclude that the directors achieved the best reasonably available value the court must determine that deal protection measures did not create an unreasonable obstacle to other bidders.

222. *Lear*, 926 A.2d at 122. *Topps* provides an illustration of this. The board agreed to sell the company to a private equity firm. When the transaction was announced, the company’s primary competitor sought to make a higher offer. *Topps*, 926 A.2d at 62. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003), provides another example. In *Omnicare*, three companies competed in the same industry. When it became apparent that two were going to merge, the third intervened with a superior offer. *Id.* at 920-27.

223. *Lear*, 926 A.2d at 107, 119.

buyer would acquire the corporation included a two-tiered termination fee payable if Lear accepted a superior proposal.<sup>224</sup> The issue was whether the termination fee had prevented others from making a superior offer. The court concluded that the termination fee (2.4% of enterprise value) was “hardly of the magnitude that should deter a serious rival bid.”<sup>225</sup> In upholding the effectiveness of Lear’s post-signing market check, the court noted that others would not be deterred from submitting superior proposals because the purchaser, Mr. Icahn, had a reputation for “happily stepping aside and cashing in his equity stake at a substantial profit when other bidders submit more attractive offers.”<sup>226</sup> Also, Mr. Icahn had contractually bound himself to vote his shares in favor of a deal approved by the company’s board.<sup>227</sup>

*Topps* provides another example. *Topps* had received an unsolicited expression of interest from Upper Deck, its chief competitor while it was negotiating a deal with by a private equity fund headed by Michael Eisner. The *Topps* board approved the deal with the Eisner group without pursuing the Upper Deck proposal. The merger agreement allowed a forty-day period after the deal was announced during which the *Topps* board could seek better bids.<sup>228</sup> When that period expired the agreement allowed the board to accept an unsolicited bid if it was superior to the deal with the Eisner group.<sup>229</sup> The agreement included deal protection measures, but the court held that the advantage they gave to the Eisner group was not unreasonable.<sup>230</sup> Because these provisions would allow Upper Deck to make a superior offer if it wished to, the court concluded that the board’s

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224. The termination fee was coordinated with a “Go-Shop” provision that allowed Lear 45 days to seek a superior offer. *In re Lear*, 926 A.2d 94 at 107, 119. At the end of the “Go-Shop” period, the board could still exercise its fiduciary out and accept a superior offer. If Lear produced a superior offer within the 45 day “Go-Shop” period, the termination fee would be about 2.8 % of the equity value (1.9% of the enterprise value) of the pending transaction, but in the more likely event that a prospective purchaser would be unable to accomplish the due-diligence required to make a superior offer within this relatively short period of time, the bidder would still be able to make an unsolicited offer, but in that event the termination fee would rise to 3.5% of the equity value (2.4% of the enterprise value). *Id.* at 107, 120.

225. *Id.* at 120. The merger agreement also gave the buyer the right to match any superior offer. The court also approved this provision, noting that matching rights are common and do not deter determined potential buyers.

226. *Id.* at 121.

227. *Id.*

228. *Topps*, 926 A.2d at 86 (noting that forty days was just barely long enough).

229. *Id.*

230. *Id.* These deal protection measures allowed the Eisner group to match competing bids and allowed the Eisner group a termination fee and expense reimbursement if the company pursued another deal. *Id.* The court said these were a common provision in merger agreements and did not create a preclusive obstacle. *Id.* Indeed, they did not prevent Upper Deck from making a topping offer.

decision to sign with the Eisner group was reasonable.<sup>231</sup>

### 3. Post-Signing: A Better Deal Appears

If a board receives a higher priced offer before an approved business combination has closed, the board's duty of loyalty to the stockholders prevents it from blocking shareholders' access to the better offer.<sup>232</sup> The board must also act reasonably to accommodate the needs of a bidder who is likely to make a superior offer. In the *Topps* case, during the forty-day period when Topps could consider other deals, the company's chief competitor, Upper Deck, made a proposal to purchase Topps at a higher price. The court found that the Topps board breached its *Revlon* duty because it failed to accommodate Upper Deck's need for additional information that would have allowed it to make a potentially superior offer.<sup>233</sup> In the court's view, the board seemed to be more interested in placing obstacles in the way of Upper Deck's higher-priced offer than in seeking the best price for stockholders. The court also noted that the board's actions tended to favor the bidder who "had pledged to retain management."<sup>234</sup>

### 4. Conclusion: Mere Negligence Violates Duty of Care

In claims for injunctive relief, judicial analysis of the directors' decisions regarding the corporation's efforts to enter into a business combination involves a highly nuanced assessment of the market for corporate control, the availability of financing, the needs and expectations of various types of potential buyers, the needs of the corporation, "signals" sent and received by market participants, and the board's reaction to these multiple and often ambiguous factors. Such an analysis clearly goes beyond the crude level of review required to find "gross negligence." In none of these cases does the court find that the directors acted with gross negligence. Rather, in all of them it examines the "reasonableness" of their efforts to achieve the best deal for stockholders. Thus, in the context of a claim for injunctive relief, the court has adopted what amounts to a

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231. *Id.* The court also noted that Topps had a rational reason to be suspicious of Upper Deck's motives and that Upper Deck was cherry picking. *Id.* It only wanted the Entertainment division which would have left Topps with its foundering Confectionary business which it had already tried and failed to sell. *Id.*

232. *Revlon*, 506 A.2d at 185.

233. *See Topps*, 926 A.2d at 91-92. The court held that the board's decision to not declare that Upper Deck's bid would qualify for continued negotiation after the forty day go-shop period was unreasonable. And, the board's reliance on the terms of the Upper Deck standstill agreement is misplaced. *Id.* at 88.

234. *Id.* at 88.

negligence standard by which to judge the duty of care.

*B. Reasonableness of the Board's Decision*

Proof that the board followed a reasonable decision-making process is not enough to satisfy enhanced scrutiny. Although a decision by an independent and careful board would be entitled to judicial deference under the business judgment rule, enhanced scrutiny requires the court to review the merits of the challenged decision to see if it is within a range of reasonable choices. This aspect of enhanced scrutiny not only violates the business judgment rule's policy against judicial second-guessing, it also creates the possibility that the court may venture beyond its jurisdiction.

The Delaware Court of Chancery is a court of equity, as is the Delaware Supreme Court when it considers appeals from the Court of Chancery. A court of equity has the power to provide an equitable remedy for breach of fiduciary duty or for violation of law. But, in the absence of a violation of law or a breach of fiduciary duty, the court does not have the power to enjoin or invalidate a transaction, or grant other types of remedy. Quite simply, in the absence of a wrong, there is nothing to remediate.

The court's review of a business decision is limited to determining whether the directors satisfied their duties of loyalty and care.<sup>235</sup> When a court is called on to give enhanced scrutiny to a transaction that has been approved by disinterested and independent directors, the usual concerns that implicate a breach of the duty of loyalty are not present. And, once the directors have satisfied the first prong of the enhanced scrutiny test by proving that they followed a reasonable decision-making process, the duty of care is no longer in issue. Thus, the second prong of the test requires the court to assess the reasonableness of a business decision made by independent, disinterested, and careful directors. This invitation to engage in second-guessing creates the possibility that a court might enjoin or invalidate a transaction untainted by breach of fiduciary duty merely because the court did not find the directors' decisions to be reasonable.<sup>236</sup> On the other hand, the inquiry into the reasonableness of the directors'

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235. See discussion *infra* Part III for a discussion of the business judgment rule.

236. Furthermore, the contract rights of third parties must also be taken into account. The Delaware courts have held that a contract that requires directors to breach their fiduciary duties is invalid and unenforceable. See *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 104 (Del. Ch. 1999) (noting that Delaware will nullify the contractual rights of a suitor where the contract impinges on the board's ability to exercise its fiduciary obligations to shareholders); see also Regan, *supra* note 125, at 1. The rights of a third party to enforce an agreement, or particular terms within an agreement—the approval of which is tainted by breach of fiduciary duty—are subordinated to the rights of stockholders to a remedy for that breach of duty. *QVC*, 637 A.2d at 51. But, what about the rights of a third party when the court enjoins the contract because it disagrees with the reasonableness of the contract terms?

decision can be justified by the need to confirm that the decision was made in “good faith.”

*C. Good Faith*

Good faith is part of the duty of loyalty.<sup>237</sup> In the context of a business combination, the duty of loyalty requires directors to base their decisions on a good faith belief that their decisions will serve the best interests of the stockholders. Those interests are served by achieving a transaction that will maximize the value of their shares. The second prong of the enhanced scrutiny test requires the court to determine whether the board’s decisions regarding the process leading to the transaction and the decision to approve the transaction were within a range of choices that would be reasonable in the circumstances. In this context, the reasonableness of the board’s decisions would be measured by whether they are likely to achieve the objective of maximizing the value of the stockholders’ shares. A decision that is likely to achieve that objective would be reasonable. A decision that is not likely to achieve that objective would not be reasonable.

If one assumes that a person intends to achieve the likely consequences of his actions, it follows that the motive for pursuing a particular course of action can be inferred from its probable result. Thus, a court can infer that a board’s decision to pursue a course of action that is reasonably likely to achieve a value maximizing transaction was motivated by a good faith belief that those actions would achieve precisely that result. On the other hand, a court can also infer that a board’s decision to approve a course of action that is not reasonably likely to lead to a value maximizing transaction was not motivated by a good faith belief that those actions would maximize value. Thus, the court’s review of the reasonableness of the board’s decision provides a way to determine whether the directors were motivated by a good faith belief that they were serving the best interests of stockholders. A court can reasonably conclude that a decision, not within the range of choices that would be likely to maximize shareholder value, was probably not intended to serve stockholders’ best interests and thus was inconsistent with the directors’ duty of loyalty.

Independent, disinterested directors are presumed to have acted in good faith. Before the court can inquire into the reasonableness of their decision, the plaintiff must produce evidence that establishes reason to question the directors’ good faith.<sup>238</sup> For example, independent,

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237. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

238. The plaintiff has the burden of rebutting the presumption that careful and disinterested directors acted in good faith. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Brehm v. Eisner*, 746 A.2d 244 (2000).

disinterested directors who have followed a reasonable decision-making process may, at the end of the process, decide to reject an apparently more valuable offer in favor of an apparently inferior offer tendered by a bidder who has promised to employ the company's senior managers in similar positions at similar salaries.<sup>239</sup> These facts raise a question regarding the directors' good faith.<sup>240</sup> Did the directors really believe, in good faith, that the less valuable deal was in the stockholders' best interests, or did they allow their desire to help senior managers to remain in office to unduly influence their decision? The possible inference that the directors might have favored the interests of the managers over the interests of the stockholders is sufficient to require the directors to justify their actions by showing that, despite the apparent disparity in price, their decision was reasonable in the circumstances. If the directors can not satisfy this proof, the inference that the decision was not made in good faith stands and a violation of the duty of loyalty has been established.

This mode of thinking seems to have influenced the Court of Chancery in two recent decisions. In *Topps*, the court held that the board's unwillingness to cooperate with a prospective bidder, who would have paid a higher price, might have been influenced by the favored bidder's promise to preserve the jobs of senior corporate managers. Similarly, in *Netsmart*, the facts suggest that the board's decision to seek bids exclusively from financial buyers and to exclude strategic buyers from the pool of potential purchasers might have been explained by the financial buyers' need to retain existing management to run the company and the strategic buyers' probable inclination to fire existing management to use its own managers to run the combined company.<sup>241</sup>

The second prong of enhanced scrutiny is only appropriate where the facts establish a reasonable basis to doubt that the board's decisions regarding the challenged transaction were based on a good faith belief that they would serve the best interest of stockholders. In the absence of such

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239. See *Citron v. Fairchild Camera and Instrument Corp.*, 1988 WL 53322, at \*16 (Del.Ch. 1988), *aff'd* 569 A.2d 53 (Del. 1989) (noting, by way of example, that a lack of good faith can be shown where "an apparently disinterested board makes a judgment that is essentially inexplicable except on the basis of an otherwise unproven inappropriate motive—such as personal favoritism or antipathy. Such a case might arise, for example, where an apparently disinterested board rejects a higher bid in favor of a lower one, on the same terms").

240. If the jobs at issue belong to the directors themselves, the analysis is much more straightforward. The directors have a direct self-interest in protecting their jobs. Under the traditional business judgment rule, the directors would have to prove the entire fairness of their decision.

241. 924 A.2d at 198-99 (noting that management favored pursuing a private equity deal that would preserve their jobs as opposed to strategic deals that would likely lead to the termination of their employment, and disavowing the obvious implication that the board had "consciously pursued objectives at odds with getting the best price").

facts, the presumption that independent, disinterested directors acted in good faith stands, and the court should not second-guess the board's decisions. In the absence of a violation of law or a breach of fiduciary duty, the court is without power to invalidate the challenged transaction. An inquiry into the reasonableness of the transaction in the absence of a breach of duty creates the possibility that the court may take action that exceeds its power.

#### VI. NO ENHANCED SCRUTINY OF CLAIMS FOR DAMAGES

When a plaintiff challenges a decision to approve a business combination after the deal has closed, equitable remedies are no longer available. It is too late for injunctive relief, and rescission is not available because, as a practical matter, a completed merger cannot generally be unwound.<sup>242</sup> Accordingly, the plaintiff is left with only a claim to recover financial damages from the directors who allegedly breached their fiduciary duties when they approved the transaction.<sup>243</sup>

Unlike a claim for injunctive relief, the courts will not allow plaintiffs who seek to recover financial damages from the directors to simply allege that the directors did not act in a way that was designed to achieve the best available price for shareholders. In reviewing claims for damages, the courts emphasize that *Revlon* did not create a new duty requiring directors to seek to get the best available transaction.<sup>244</sup> Rather, *Revlon* and its progeny merely recognized that in some circumstances the traditional fiduciary duties of care and loyalty<sup>245</sup> are to be focused on "a specific objective: maximizing the sale price of the enterprise."<sup>246</sup> For this reason, the courts require plaintiffs who seek to recover damages on a *Revlon* claim to "plead sufficient facts to support the underlying claims for a breach of fiduciary duties in conducting the sale."<sup>247</sup>

##### A. *Duty of Care Claims*

As a practical matter, a claim alleging that the directors' failure to

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242. *E.g.*, *Gimbel v. Signal Cos., Inc.*, 316 A.2d 599, 603 (Del. Ch. 1974); *McMillan v. Intercargo Corp.*, 768 A.2d 492, 500 (Del. Ch. 2000); *Goodwin v. Live Entm't, Inc.*, No. 15,765, 1999 WL 64265, at \*6 n.3 (Del. Ch. Jan. 25, 1999); *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 728 (Del. Ch. 1999). In Delaware this amounts to a substantive principle of law, rather than a finding of fact.

243. *McMillan*, 768 A.2d at 500.

244. *Malpiede v. Townson*, 780 A.2d 1075, 1083 (Del. 2001).

245. *Id.*

246. *Id.*; see also *Revlon*, 506 A.2d at 182-183, *QVC*, 637 A.2d at 43-44; *Barkan*, 567 A.2d at 1286; *MacMillan II*, 559 A.2d at 1288.

247. *Malpiede*, 780 A.2d at 1084.

achieve the best available price because they breached their duty of care will seldom, if ever, support an effort to impose personal financial liability on the directors. Most, if not all, Delaware corporations include an exculpation provision in their certificate of incorporation pursuant to Section 102(b)(7) of the Delaware General Corporation Law.<sup>248</sup> Such a provision prohibits the imposition of personal liability on directors for breach of the duty of care. Thus, in the context of a *Revlon* claim, “if a board unintentionally fails, as a result of gross negligence and not of bad faith or self-interest, to follow up on a materially higher bid and an exculpatory charter provision is in place, then the plaintiff will be barred from recovery.”<sup>249</sup>

There are two important points here. First, as a practical matter, the prevalence of Section 102(b)(7) exculpation provisions in corporate charters means there is little likelihood that a court will be called upon to decide a *Revlon* claim for damages based on an alleged breach of care. Second, if there is still a corporation that does not include a Section 102(b)(7) provision in its charter, a *Revlon* claim for damages based on the duty of care would require a showing that the directors acted with “gross negligence.” As a consequence, the usual arguments advanced by plaintiffs regarding the reasonableness of the process by which the directors developed the challenged transaction would be unavailing.

#### B. *Duty of Loyalty Claims*

To impose personal liability on directors, a *Revlon* claim must assert that the directors’ failure to secure the highest attainable value was the result of a breach of the duty of loyalty.<sup>250</sup> There are two ways to establish a breach of the duty of loyalty. The plaintiff may follow the traditional approach of alleging in the complaint (and proving at trial) that the directors were under the influence of factors that gave them a personal incentive not to maximize value.<sup>251</sup> Alternatively, the plaintiff can argue that the directors’ decision to approve the challenged transaction was not made in good faith.<sup>252</sup>

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248. 8 Del. C. §102(b)(7).

249. *McMillan*, 768 A.2d at 502; *see also Goodwin*, 1999 WL 64265, at \*5-6, \*20 (noting that “Goodwin’s disclosure, Revlon, and unfair dealing claims will therefore survive or fail summary judgment depending on the presence or absence of record evidence of bad faith or disloyalty.”); *Lukens*, 757 A.2d at 730-32 (dismissing the case because of the presence of the 102(b)(7) exculpatory provision).

250. *Id.* at 501.

251. *E.g.*, *McMillan*, 768 A.2d at 502; *Goodwin*, 1999 WL 64265, at \*20.

252. *McMillan*, 768 A.2d at 502.

### 1. Lack of Impartiality

Where the plaintiff alleges that the directors were self-interested or acting under the influence of a self-interested party, the *Revlon* analysis becomes virtually identical to the analysis under the traditional business judgment rule.<sup>253</sup> In both situations the plaintiff is put to the burden of pleading and proving facts that create reason to doubt the directors' impartiality. Under the traditional business judgment rule, when the plaintiff places the directors' loyalty in issue by successfully challenging their impartiality, the burden shifts to the compromised directors to prove that the transaction was entirely fair to corporation.<sup>254</sup> Under the enhanced scrutiny standard, proof that the challenged transaction was entirely fair is not enough to avoid personal liability. Rather, the compromised directors must prove that the challenged transaction achieved the *best* available deal for the stockholders.<sup>255</sup> Depending on the circumstances, proof that a deal was the "best" may be more difficult than proof that the deal was within a range of fairness.

But, this is speculation. So far, no case has reached this point. All of plaintiffs' efforts to impose personal liability on directors based on *Revlon* claims have been dismissed on the pleadings or rejected on motions for summary judgment,<sup>256</sup> except one.

### 2. Lack of Good Faith

That one exception was *Ryan v. Lyondell Chemical Co.*,<sup>257</sup> a class action for damages<sup>258</sup> in which the plaintiff alleged that the directors of Lyondell had not acted in good faith when they approved the sale of the company.<sup>259</sup> The defendant's motion for summary judgment was denied because the record did not rule out the possibility that the process by which the directors approved the sale was so deficient that it might reflect an

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253. See Veasey, *supra* note 134, at 399 (equating entire fairness with enhanced scrutiny).

254. See *infra* Part III for a discussion of the "entire fairness" standard.

255. *Revlon*, 526 A.2d at 185.

256. *Malpiede*, 780 A.2d at 1101; *McGowan v. Ferro*, 859 A.2d 1012, 1032 (Del. Ch. 2004); *McMillan*, 768 A.2d at 508; *In re CompuCom Sys., Inc. S'holders Litig.*, No. 499-N, 2006 WL 2481325, at \*11 (Del. Ch. Sept. 29, 2005); *In re Prime Hospitality, Inc. S'holders Litig.*, No. 652-N, 2005 WL 1138738, at \*10 (Del. Ch. May 4, 2005).

257. No. 3176-VCN, 2008 WL 2923427 (Del. Ch. July 29, 2008).

258. In *Ryan*, the merger had been consummated so equitable remedies were no longer available. An award of financial damages against the directors was the only remedy still available to plaintiff. See *id.* at \*11 (noting that plaintiff is only entitled to damages upon a showing that "the Board either failed to act in good faith in approving the Merger or otherwise acted disloyally").

259. *Id.* at \*4

intentional disregard of their Revlon duties in violation of the good faith component of their duty of loyalty.<sup>260</sup>

Lyondell's certificate of incorporation included a Section 102(b)(7) exculpation provision, so the plaintiff was forced to ground his *Revlon* claim on a breach of the duty of loyalty.<sup>261</sup> The facts did not support any of the traditional approaches to establishing a duty of loyalty claim.<sup>262</sup> Instead, the plaintiff argued that the directors' failure to take more aggressive steps toward the pursuit of the best available transaction and their willingness to accept certain deal protective measures reflected an intentional disregard of their *Revlon* duties.<sup>263</sup> Such intentional dereliction of duty, the plaintiff argued, constituted bad faith<sup>264</sup> which constituted a violation of the duty of loyalty.<sup>265</sup>

The court accepted the plaintiff's argument. It held that the record could reasonably support the inference that (1) the directors' failure to attempt to negotiate a better deal,<sup>266</sup> (2) their failure to do a pre-signing market survey,<sup>267</sup> and (3) their failure to do an adequate post-signing market check<sup>268</sup> reflected their conscious disregard of their duties under the *Revlon* doctrine.<sup>269</sup>

The defendants sought leave to file an interlocutory appeal from the trial court's denial of their motion for summary judgment. The trial court denied that request,<sup>270</sup> but the Delaware Supreme Court, in an unusual

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260. *Id.* at \*11, \*18-19. The board had not participated in the negotiations regarding price. *Ryan*, at \*4. Price had been negotiated by the company's CEO. *Id.* The board signed the agreement six days later, after having received advice from independent financial advisors. *Id.* at \*1. The board did not do a pre-signing market survey, and the post-signing market check was arguably inhibited by deal protection measures in the merger agreement. *Id.*

261. *Id.* at \*11.

262. Only one of the eleven directors, the CEO, was employed by the company. *Id.* at \*4 (identifying the ten independent directors and the eleventh member who was the CEO). The other ten were outsiders with no conflicting self-interest. *Id.* at \*10 - \*11. Their independence from the proponents of the transaction was beyond challenge. *See id.* at \*10 n.59 (summary judgment was granted against plaintiff on all general duty of loyalty claims). In fact, the court acknowledged they were "well-credentialed, independent directors." *Id.* at \*4.

263. *Id.* at \*11 - \*13 (discussing cases applying *Revlon*).

264. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 64 -66 (Del. 2006) (holding that "intentional dereliction of duty, a conscious disregard for one's responsibilities" constitutes bad faith for which exculpation from personal liability is not available).

265. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (holding that a bad faith violates the duty of loyalty).

266. *Id.* at \*14.

267. *Id.*

268. *Id.*

269. *Id.*

270. *Ryan v. Lyondell Chem. Co.*, C.A. No. 3176-VCN 2008 WL 4174038 (Del. Ch. Aug. 29, 2008).

exercise of its discretion, agreed to hear the appeal.<sup>271</sup> Then, in an *en banc* decision, the Supreme Court reversed the trial court's decision and remanded with directions that summary judgment be entered in favor of the defendants.<sup>272</sup>

The Supreme Court acknowledged that the directors' duty of loyalty required them to perform their decision-making function in good faith.<sup>273</sup> The court also acknowledged that an intentional dereliction of a known duty would reflect an absence of the good faith which would constitute a violation the duty of loyalty.<sup>274</sup> But, it found that the trial court's application of these principles to the facts presented by the plaintiff's case was flawed. The process by which the Lyondell board reached its decision to approve the sale of the company might have been imperfect, but these imperfections implicated only the duty of care.<sup>275</sup> They did not demonstrate an intentional dereliction of the board's *Revlon* duties.

The Supreme Court explained that trial court's analysis erred because it was based on the view that *Revlon* and its prodigy had defined particular ways in which a board must perform its *Revlon* duties.<sup>276</sup> In rejecting that view, the Supreme Court held that "[t]here is only one *Revlon* duty—to '[get] the best price for the stockholders at a sale of the company.'"<sup>277</sup> It explained that "there is no single blueprint that a board must follow to fulfill its [*Revlon*] duties."<sup>278</sup> Accordingly, "[n]o court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control."<sup>279</sup>

Here, the directors' failure to conduct an auction, or to conduct a pre-signing market check might implicate the duty of care,<sup>280</sup> but "there is a vast difference between an inadequate or flawed effort to carry out

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271. *Lyondell Chem. Co v. Ryan*, No. 401, 2008, 2008 WL 4294938 (Del. Sept. 15, 2008).

272. *Id.*

273. *Id.* at \*3 (discussing *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27 (Del. 2006)).

274. *Id.* at \*4 (discussing *Stone v. Ritter*, 911 A.2d 362 (Del. 2006)).

275. *Id.* at \*6

276. *Id.* at \*6 (holding that the trial court's conclusion that the directors must follow one of several course of action was erroneous), and at \*7 (explaining that the trial court's decision was based on the incorrect view that *Revlon* required directors to follow one of three courses of action: an auction, a pre-signing market survey, or market research that provides a precise knowledge of the company's value).

277. *Id.* (quoting *Revlon*, 506 A.2d at 182.)

278. *Id.* at \*6 (quoting *Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279, 1286 (Del. 1989)).

279. *Id.* at \*6.

280. *Id.* at \*6-\*7.

fiduciary duties and a conscious disregard for those duties.”<sup>281</sup> Only a complete and utter failure to make an effort to confirm that the deal under consideration represents the best reasonably available price would implicate the kind of bad faith that would constitute a breach of the duty of loyalty.<sup>282</sup>

Thus, it would take an extreme, and highly unlikely, set of facts to support a loyalty claim based on a board’s failure to perform its *Revlon* duties.<sup>283</sup> Accordingly, it appears that independent and disinterested directors who make a good faith effort to comply with their *Revlon* duties are extremely unlikely to be held personally liability on a claim that they failed to achieve the best available price.

This makes sense. If it were otherwise, independent, disinterested directors would face personal liability if a trial court, with the benefit of hindsight, were to disagree with their strategic decisions regarding the process by which they sold their company. Moreover, the exposure they would face would be greater than that faced by directors who engage in self-dealing. A self-interested director can escape liability by showing that the self-interested transaction was accomplished at a fair price.<sup>284</sup> But in the *Revlon* context, the fact that the transactional price was merely fair would not be a defense.<sup>285</sup> To avoid liability in the *Revlon* context directors would have to prove that they achieved the “best” reasonably available price.<sup>286</sup> If they failed to do so, they would be personally liable for the difference between the value of the deal they accepted and the value of a hypothetical deal that the court, with the benefit of hindsight, believes they should have achieved.

The astonishing inequity of that result explains why it would take a truly extreme set of facts to establish a disregard of *Revlon* duties that was sufficiently egregious to justify the imposition of personal liability on the independent directors who approved the sale.

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281. *Id.* at \*7.

282. *Id.* (noting that only a knowing and complete failure to undertake their responsibilities would be a breach of the duty of loyalty).

283. *Id.* (citing *In re Lear Corp. S’holders Litig.*, 2008 WL 4053221 (Del. Ch. 2008) for the proposition that it would take an extreme set of circumstances to establish a dereliction of duty in the transactional context).

284. *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993)(holding that self-interested directors were not liable for approving a compensation plan that was entirely fair).

285. In the *Ryan* case, the trial court’s finding that the merger was accomplished at an “undeniably” fair price.<sup>285</sup> *Ryan* at \*23.

286. The *Revlon* Doctrine requires the board to seek the best available price. *See infra* notes 29-129 and accompanying text.

## VII. CONCLUSIONS

### A. *Focus and Definition of the Board's Duty*

The nature of the transaction should determine whether the board's fiduciary duties are focused primarily on the corporation or the welfare of the stockholders. A transaction that involves enterprise issues requires the board to focus on the best interests of the corporation. A transaction that involves ownership issues, matters that will affect the stockholders' ownership of the corporation's shares, requires the board to focus on the best interest of the stockholders. A business combination will necessarily affect the stockholders' ownership in the corporation because it will convert their shares into cash, debt securities, or shares of the combined business entity.

In negotiating the terms of a business combination, the board is, in effect, acting as an agent on behalf of the stockholders. It is a basic principle of agency law that an agent owes its principal fiduciary duties of loyalty and care when the agent acts on behalf of the principal. Thus, in the context of a business combination, the board's duty of loyalty is owed to the stockholders. This duty requires the board to focus its actions and decisions on the stockholders' best interests. These interests require the board to seek to achieve the best available deal.

What constitutes the best available deal is also resolved by the nature of the transaction under consideration. A cash-for-stock transaction amounts to a sale of the shareholders' ownership of the corporation in exchange for cash. It terminates the stockholders' equity participation in the enterprise. It represents the stockholders' last opportunity to profit from their investment in the corporation. These facts mean that the directors' duty to serve the stockholders' best interests is defined in terms of achieving the highest available price for the shares. If a superior transaction should appear, the board's duty to stockholders would prevent the board from denying the stockholders access to the superior deal.

In a stock-swap business combination, the board is negotiating a deal that will change the nature of its stockholders' investment, but it will not terminate their equity participation as owners of the on-going enterprise. The stockholders' shares of their corporation will be converted to shares of the combined business entity, a larger entity with more shareholders. In deciding to approve such a transaction, the board must reasonably believe that the stockholders of their corporation will be better off as stockholders of the combined corporation. This conclusion has two aspects, one long-term and one short-term. First, the board must determine that the long-term prospects of the resulting corporation are better than those of the corporation in which the stockholders presently hold stock. If not, there is

no reason to do the deal. Second, the board must assure that the exchange ratio fairly reflects the value of their corporation's contribution to the resulting corporation. If a stock-swap merger also happens to involve a change of control, the board is negotiating the terms under which its stockholders lose voting control of the corporation. This means there is a separate element of value to be sought in the negotiation—a control premium.

Change of control is irrelevant to the problem of defining the board's duty when a third party makes an arguably more valuable offer for the company's shares. The fact that the pending transaction does not involve a change of control should not allow the board to proceed with a less valuable transaction and deny the stockholders the opportunity to accept the more valuable offer. By the same token, the fact that a pending offer will result in a change of control, should not require the board to abandon a pending transaction to allow the stockholders to accept an all cash offer. In both instances the board's duty is defined by the fact that the transaction requires the board to function as an agent for the stockholders. Its fiduciary duty as an agent requires that it pursue the course of action that will best serve the stockholders' interests. If the board believes in good faith that the stockholders will be better off as equity participants in the long-term prospects of the combined business entity, it may proceed with the pending transaction. But, if the board believes that the alternative transaction promises more value for the stockholders, it must abandon the pending deal and allow stockholders to pursue the alternative transaction.

#### *B. Standard of Review*

The Delaware courts' overuse of enhanced scrutiny has led to judicial second guessing of business decisions made by disinterested, independent and diligent directors whose decisions would ordinarily be entitled to judicial deference. As a result, when an intervening transaction becomes available and the inevitable litigation ensues, the final decision as to the sale of the company is made by the court. But such decisions should be made in the boardroom; not the courtroom.

Assuming the absence of facts that give reason to doubt the board's impartiality or that show breach of the duty of care, enhanced scrutiny should apply only where the circumstances surrounding the board's approval of the challenged business combination suggest that the board's decision may not have been based on a good faith belief that it would serve the stockholders' best interests.

The specter that directors' decisions might be motivated by factors irrelevant to their duty to the stockholders is raised when the circumstances suggest that the directors may have had an ulterior purpose. Enhanced

scrutiny should be used only where necessary to resolve ambiguity regarding the directors' motives. For example, a board's decision to defend its corporation against a hostile takeover may have been motivated by a desire to protect the corporation from reasonably perceived harm, but it may also have been motivated by the directors' desire to retain their corporate offices. It was to resolve this type of ambiguity that the Supreme Court created the where the circumstances suggest that the board may have had ulterior motives for approving the sale of the company to a particular buyer, enhanced scrutiny is appropriate to allow the directors concept of enhanced scrutiny in the *Unocal*<sup>287</sup> decision. Enhanced scrutiny meant that the directors whose motives were in doubt would be required to prove that they reasonably believed the takeover threatened the stockholders and they took reasonable action to neutralize that threat.<sup>288</sup> Similarly, in the context of a decision to approve a business combination between corporations to remove the question as to their good faith by showing that they followed a process that they believed was reasonably likely to achieve the best deal for the stockholders, and that the transaction they approved was a reasonable way to accomplish that objective.

For example, a decision that was apparently motivated by a desire to preserve the jobs of managers should be subject to enhanced scrutiny. Thus, enhanced scrutiny is proper to review a board's decision to limit the field of prospective purchasers to those who would be likely to retain the company's managers,<sup>289</sup> as well as where the board's decision to reject a potentially more valuable offer could be explained by a belief that the favored purchaser intended to retain the company's managers.<sup>290</sup> In both instances, the board's failure to show that its decision in these particular circumstances would support the conclusion that the decision was not based on a good faith belief that it would serve the best interests of stockholders and thus constituted a violation of the duty of loyalty.

This approach is consistent with the results reached in the cases which have granted injunctive relief: *MacMillan*<sup>291</sup> (self-interest and corrupt auction), *QVC*<sup>292</sup> (favoring bidder who would retain the target company's CEO as the CEO of the surviving entity), *Netsmart*<sup>293</sup> (limiting search to financial buyers who would retain management), *Topps*<sup>294</sup> (favoring bidder

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

288. *Id.* at 955 (stating "[the directors] satisfy that burden by showing good faith and reasonable investigation").

289. *See Netsmart*, 924 A.2d at 171 (discussing how the board failed to take reasonable steps to seek out strategic buyers).

290. *Revlon*, 506 A.2d at 173; *Topps*, 926 A.2d at 58.

291. *Macmillan II*, 559 A.2d at 1264.

292. *QVC*, 637 A.2d at 1251.

293. *Netsmart*, 924 A.2d at 176.

294. *Topps*, 926 A.2d at 61.

who was likely to retain management). It is different from the approach taken by the court in the anomalous case of *Ryan*.<sup>295</sup> In that case the court found that the procedures followed by the board in its effort to sell the company were so inconsistent with the teachings of *Revlon* and its progeny, that it could be construed to reflect bad faith.<sup>296</sup> But, procedure is a component of the duty of care, and the court has held in *Disney* that a breach of the duty of care does not support a claim for bad faith unless it is also an intentional disregard of the duty of care which is bad faith.<sup>297</sup>

The approach advocated in this paper would limit the concept of good faith to an analysis of the claims based on a duty of loyalty. That duty requires the directors to base their decisions and actions on a good faith belief that they will serve the best interests of the beneficiary of the fiduciary duty. By limiting enhanced scrutiny to circumstances that clearly implicate a potential breach of the duty of loyalty, the court would avoid the possibility of exceeding its power by granting a remedy where there is no breach of duty.

By restoring the business judgment rule to judicial review of business combinations, Delaware will return to basic principles. No longer will judges second guess business decisions made in good faith by independent, disinterested, and diligent directors. No longer will the final decision regarding the sale of a company be made by chancellors. Instead, it will be made by the directors elected by the stockholders to make such decisions.

At this point it is useful to remember that enhanced scrutiny is performed in an environment where the business judgment rule's presumption that the directors' disinterestedness, independence, and diligence stands un-rebutted. If it were not so, the transaction would be reviewed under the more rigorous entire fairness standard. Thus, enhanced scrutiny is performed under circumstances in which the directors' decision would ordinarily be entitled to judicial deference.

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295. *Ryan*, 2008 WL 2923427, at \*1.

296. *Id.*

297. *Disney*, 906 A.2d at 67; see also *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (explaining that the obligation to act in good faith is part of the duty of loyalty).