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THE ILLUSION OF THE ENHANCED UNOCAL STANDARD

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ABSTRACT

From the time of the Delaware Supreme Court’s 1985 decision in the case of *Unocal Corporation v. Mesa Petroleum Co.,*[1] the word ‘Unocal’ has taken on a meaning of its own. Once simply the name of a corporation, it now signifies the test or principle developed in that case to wit: because of the omnipresent spectre of self-interest where the board of directors of a corporation adopts a defensive response to a hostile takeover offer, in order to be afforded the protection of the business judgment rule, the directors of such a company must have clearly identified that the offer posed a threat to corporate policy and effectiveness and such defensive response must be reasonable in relation to the threat posed.[2]

Prior to *Unocal*, and as re-stated in *Unocal*, in the face of an inherent conflict, “the directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another’s stock ownership.”[3] The innovation of *Unocal* therefore was the introduction of the further aspect of “the element of balance”[4] as the Delaware Supreme Court described it in the case, or “proportionality” as it is now widely described and understood. It is this proportionality element that is the subject of this paper. Likewise, it has been the topic of much academic discussion,[5] and for good reason. The development of the proportionality prong since *Unocal* has been lopsided, making it hard to settle on a bright-line rule of application. For instance, in *Unocal* itself, a discriminatory self-tender offer was found to be a reasonable response by the Supreme Court, yet in *AC*

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[1] 493 A.2d 946 (Del.1985).
[2] This paraphrases the principle developed in that case.
[3] *Unocal* at 955 (quoting Cheff v. Mathes, 199 A.2d 548, 554-555 (Del. 1964)).
[4] *Id.*
[5] *See, e.g.*, Ronald J. Gilson and Reinier Kraakman, *Delaware’s Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989); Mark J. Lowenstein, *Unocal Revisited: No Tiger in the Tank*, 27 J. CORP. L. 1 (2001-2002); Paul L. Regan, *What’s Left of Unocal?*, 26 DEL J. CORP. L. 947 (2001).

Acquisitions Corp. v. Anderson, Clayton & Co.,[6] decided shortly after *Unocal*, the Delaware Chancery held a self-tender offer to be an unreasonable response to a hostile takeover bid. This could easily be explained by the fact that the proportionality of a defensive measure often turns on the facts of each case.[7]

What cannot easily be explained is the consistency with which the most commonly used defensive measures have been found to be reasonable in respect of a wide range of threats, so much so that it now appears that as long as a threat is reasonably identified, a defensive measure is likely to be found to be reasonable, at least as far as the Delaware Supreme Court is concerned.[8] I posit that the reason for this is the underlying principle of corporate law in Delaware as well as many other U.S. states, i.e., "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, except as may be otherwise provided . . . . "[9] The courts have held that in the broad context of corporate governance, a board of directors "is not a passive instrumentality,"[10] and therefore has "both the power and duty to oppose a bid it perceive[s] to be harmful to the corporate enterprise."[11]

To my mind therefore, the case law suggests that in their review, the courts are more concerned with whether the board has determined that a bid is harmful to the corporate enterprise. This is the burden which the directors have to discharge, after which the response is almost certain to be sanctioned as reasonable. If this is the reality, then why do the

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[6] 519 A.2d 103 (Del. Ch. 1986).

[7] In *Unocal*, the hostile takeover bid was a coercive two-tier tender offer, while the takeover offer in *Anderson, Clayton* was an all-shares all-cash offer.

[8] The Delaware Chancery and Supreme Court have found different responses to be proportional. *See, e.g.*, Moran v. Household International Inc., 500 A.2d 1346 (Del. 1985) (a Rights Plan was found to be reasonable in relation to the threat of an inadequate offer); Versata Enterprises, Inc. v. Selectica, Inc., 5 A.3d 586 (Del. 2010) (the threat of the loss of a Net Operating Loss (NOL) carry forward); Yucaipa American Alliance Fund II L.P. v. Riggio, 1 A.3d 310 (Del. Ch. 2010) (the threat of a "creeping acquisition" that would prevent the shareholders from receiving a control premium even while relinquishing control); Ivanhoe Partners v. Newmont Min. Corp., 535A.2d 1334 (Del. 1987) (a dividends distribution and standstill agreement were found to be reasonable responses to an inadequate (coercive two-tier) bid); *Unocal* (a discriminatory self-tender exchange offer was held to be a reasonable response to an inadequate (coercive two-tier) bid).

[9] DEL CODE ANN. TIT. 8, § 141(a) (2010).

[10] *Unocal*, 493 A.2d at 954.

[11] *Id.* at 949. *See also*, *Ivanhoe Partners*, 535A.2d at 1337.

Delaware courts go through the mechanics of a two-step analysis? Can a case be made for a single-step analysis that turns on establishing by a heightened burden on the target company's board of directors that a proposed bid is harmful to the corporate enterprise, or in the alternative that they have a plan for the company which is superior to that which will result from the bid?

The Unocal test was developed to address the all-too-real "omnipresent spectre that a board may be acting primarily in its own interests rather than those of the corporation and its shareholders,"[12] whenever it has to confront a hostile takeover offer. It is something of a challenge to determine the motivation behind a board's response to a hostile takeover bid i.e. whether a defence is in order to protect the company, its shareholders and other stakeholders,[13] or simply to protect the positions and income stream of its members. After all, "there is no art to find the mind's construction on the face."

The solution devised by the courts in *Unocal* is a process-driven one, in contrast to the purpose-driven test devised by the court in *Cheff v. Mathes*.[14] Since the courts could not objectively determine the purpose of a defensive measure, the courts laid down the process which a board must follow, in order to sustain a defensive measure. One could argue that establishing a process is not any more effective in removing the "omnipresent spectre" that the board is acting in its interest, but it seems that the process-driven model is at least a more objective standard than the subjective purpose-driven model.

To satisfy the first prong of *Unocal*, the board must have identified a threat to corporate policy and effectiveness by showing "good faith and reasonable investigation."[15] Evidence of good faith and reasonable investigation may be found in the existence of a "board comprised of a majority of outside independent directors."[16] The second prong on the other hand, requires a showing that the defensive measure is reasonable in relation to the threat identified i.e. proportional. In *Unocal*, the discriminatory self-tender exchange offer

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[12] *Unocal*, at 954.
[13] These are the "constituencies other than shareholders (i.e. creditors, customers, employees, and perhaps even the community generally)" described in *Unocal*, at 955.
[14] 199 A.2d at 554 ("[I]f the board has acted solely or *primarily* because of the desire to perpetuate themselves in office, the use of corporate funds for such *purposes* is improper.") This is the so-called "primary purpose" test devised in *Cheff*.
[15] *Unocal*, at 954 (quoting *Cheff*, at 555).
[16] *Id.* at 955.

was found to be reasonable, because the court found it to be in keeping with the principle that "the minority stockholder shall receive the substantial equivalent in value of what he had before."[17] However, the process aspect of the second prong however was not fully developed until later cases.[18]

In the end though, whatever may be identified as a reasonable response to a potential takeover, the underlying problem is a corporate issue that remains unresolved even after all this time i.e. the division of powers within a company. What is the role of the shareholders vis-à-vis the directors of a company? Who has a right to sell the company or refuse to sell the company? What is an acceptable reason for refusing to sell a company? What is the role of a company in society? Does the company owe an obligation to any interests outside of the shareholders? The Unocal test and the circumstances in which it arises are but one aspect of these larger questions.

This paper attempts to cast the Unocal test in the light of these issues, and to examine what if any progress, the proportionality standard has brought into the larger discussion of directors' duties. Part II gives a brief rundown of some theories of the corporation and its role as an entity; it also discusses briefly the separation of roles of the major players within the corporation since it is this conflict that is often reflected in Unocal-type cases. Part III addresses early judicial attempts at resolution of the discord and creation of standards of conduct for directors in their role as fiduciaries. Part IV introduces the Unocal case and the doctrine adopted therein. Part V does a comparison of the proportionality theory between Uno al and other aspects of law. Part VI will trace the evolution of the Unocal doctrine and how it has been applied in subsequent cases, as well as discovering any inconsistencies in its application; this part will also address the dichotomy between the Court of Chancery and the Delaware Supreme Court. Part VII reviews proportionality outside Delaware, while Part VIII

[17] *Id.* at 956.
[18] See discussion *infra* Part VI.

reviews proportionality in Delaware after a series of important cases. Finally, the paper will discuss the current state of Unocal, and the possibility of the Delaware court retracing its steps to better resolve the issues which Unocal was intended to resolve.

A. Theories of the Firm

It is not certain at this point in history, that there is a consensus on a number of issues at the heart of corporate law; [19] one such issue being the role of a corporation in society.[20] Another is the allocation of control powers among the key constituents of a corporation particularly the directors and the shareholders. There are two prominent schools of thought around each of these issues.

To the first issue, there is a school of thought that the corporation is the private property of its owners, and owes feasance first and last to its owners i.e. the shareholders.[21] Thus, the corporate apparatus should be geared towards the maximisation of benefits to the shareholders, and the directors should adopt strategies that ensure the attainment of this objective. According to this model, the corporation need not factor any other constituents into the equation since there are other avenues for protecting these other constituents.[22] In some quarters, this formulation is known as the "shareholder primacy model." The other school of thought conceives of the corporation not as property to be used solely for the pleasure of its owners, but as a tool of society with a role to benefit society as a whole.[23] Under this conception, a corporation exists not strictly for the benefit of its members, but as a social

[19] This is in spite of the fact that Hansmann and Kraakman would have us believe that there is a growing consensus on these issues; see Henry Hansmann and Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 440.

[20] For a detailed history of the evolution of the corporation in the United States and its transformations over time, see Reuven S. Avi-Yonah and Dganit Sivan, *A historical perspective on corporate form and real entity-Implications for corporate social responsibility*, *in* THE FIRM AS AN ENTITY 153, 155 (Yuri Biondi, Arnaldo Canziani & Thierry Kirat eds., Routledge 2007).

[21] William T. Allen dubbed this the "property conception of the corporation"; see William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 265 (1992) (stating that, "the corporation's purpose is to advance the purposes of these owners (predominantly to increase their wealth)). *See also*, Hansmann and Kraakman, *supra* note 19, at 441(in which this theory was described as the "standard shareholder-oriented model.") *See further*, Robert B. Thompson and D. Gordon Smith, *Toward a New Theory of the Shareholder Role: 'Sacred Space' in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001-2002).

[22] These other avenues include contract and regulation; *see*, Hansmann and Kraakman *supra* note 19, at 449.

[23] Allen, *supra* note 21, at 264, suggested several labels for this theory including 'the managerialist conception', 'the institutionalist conception,' or 'the social entity conception.'

institution deriving its source of existence by governmental fiat. In this paper, I adopt a widely used appellation for this model, i.e., the "stakeholder model."

The second debate which is closely tied to the question of what the purpose of a corporation is, is the degree of control to be exercised by the two primary constituents – the directors and the shareholders. Logically, adherents of the shareholder primacy model would have the shareholders be in control. According to Hansmann and Kraakman,

> [U]ltimate control over the corporation should rest with the shareholder class; the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders; other corporate constituencies, such as creditors, employees, suppliers, and customers, should have their interests protected by contractual and regulatory means rather than through participation in corporate governance; noncontrolling shareholders should receive strong protection from exploitation at the hands of controlling shareholders . . . . [24]

On the other hand, adherents of the stakeholder model believe that control of the corporation should not rest in the hands of the shareholders, but should be exercised on behalf of all the stakeholders by the directors. According to one report,

> If corporations were directly managed by shareholders, and the actions of management were the subject of frequent shareholder review and decision-making, the ability to rely on management teams would be diluted and the time and attention of managers could, in many cases, be diverted from activities designed to pursue sustainable economic benefit for the corporation.[25]

The different conceptions of the corporation have prevailed at different times. For instance, from the mid- nineteenth century up until the early twentieth century, the shareholder primacy model prevailed. The case of *Dodge v. Ford Motor Co.*[26] illustrates this fact. In that case, the court found for the plaintiffs, ordering the defendant to pay dividends to the shareholders and stating that;

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[24] Hansmann and Kraakman, *supra* note 19, at 440.
[25] Committee on Corporate Laws of the American Bar Association Section Of Business Law — Report On The Roles of Boards of Directors and Shareholders of Publicly Owned Corporations (Jan. 21, 2010), *available at* http://www.hunton.com/media/SEC_Proxy/PDF/SEC_Agenda_Section2.PDF.
[26] 204 Mich. 459 (1919).

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.

A number of factors within the decade after the *Ford* decision reversed the supremacy of the shareholder primacy model.[27] The sheer size of the corporation and the dispersing of ownership interests meant that shareholders were less in control of the corporation and managers effectively took over control of the corporation. This state of affairs lasted only until the 1980s when the trend was reversed again due to the rise of the cash tender hostile takeovers of that period.[28,29]

What role if any did legislation play in resolving this conflict, one may ask? In the United States, the law (both statute and common law) seems to have sided with the stakeholder and the director primacy models. For instance, in Delaware, directors are charged with managing the business and affairs of a corporation.[30] Likewise the Delaware Supreme Court in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[31] stated that "a board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders." In other states outside Delaware, boards are expressly permitted by statute to consider the interests of other constituencies apart from shareholders.[32]

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[27] These factors include the Depression, the New Deal, and World War II after which the US economy entered a period of growth; see, Martin Gelter, *Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light*, 7 NYU JOURNAL OF LAW AND BUSINESS 641, 651.

[28] Allen, *supra* note 21, at 273. *See also*, Gelter, 7 NYU JOURNAL OF LAW AND BUSINESS, at 651-52.

[29] Since then, the trend has reversed itself time and again. After the demise of the hostile takeovers of the 1980 when the shareholder primacy model thrived, the stakeholder conception was once again revived. These days however, it appears that shareholder primacy has once again reared its head. Shareholder activism has led to several initiatives which are designed to empower shareholders; *see*, Gelter *supra* note 27 at 655-56.

[30] *See supra* note 9, and the accompanying text.

[31] 506 A.2d 173, 182 (Del. 1986).

[32] See Michael Barzuza, *The State of State Anti-Takeover Law*, 95 Va. L. Rev. 1973 (2009), *available at* http://ssrn.com/abstract=1532427 (last visited on January 5, 2012) (stating that "Thirty-five states have adopted directors' duties statutes, also known as "other constituency" statutes. Typically, these statutes allow directors to take into account the interests of constituencies other than shareholders and/or the long term value of the firm.")

B. Theories of the Firm and Hostile Takeovers

The discussion around the role of the firm as an entity is not simply a theoretical discourse over which legal scholars have a fine time arguing issues which have little impact on reality. On the contrary, the reason it is such an important argument is that it goes to the root of the separation of powers within a corporation. The *Ford* case discussed earlier[33] is instructive on this point. In that case, the plaintiff shareholders brought action to compel Ford Motor Co, to pay a dividend to its shareholders. Mr. Ford[34] had other ideas for the profits declared by the company; his ambition was to "employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes." Therefore, his plan was to plough back the profits of the company into the business, rather than pay it out as a dividend to the company's shareholders. Even though it recognised that "the directors of a corporation, and they alone, have the power to declare a dividend of the earnings of the corporation, and to determine its amount,"[35] the court went ahead to order the company to pay the dividend amount decided by the court.

The interplay of the two sides of the divide can be seen from the court's decision. Mr. Ford was accused by the plaintiffs of carrying on the corporation "as a semi-eleemosynary institution and not as a business institution." In other words, Mr. Ford's conception of the firm was as a social entity and not merely as the property of its shareholders i.e. the stakeholder model, with the shareholders expectedly firmly in the camp of the shareholder primacy model. By finding that it was the directors' duty to distribute a large dividend to the shareholders, the courts sided with the plaintiffs and interfered to strip the board of the authority to make a decision that was entirely within its bounds to make. Put succinctly, the conception of the corporation often affects the decision-making powers within the corporation and determines in whose interest the corporation must be acting at all times.

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[33] *Supra*, note 26.

[34] He was the president of the Ford Motor Co. at the time.

[35] *Ford*, 204 Mich. 500 (quoting Hunter v. Roberts, Throp & Co., 83 Mich. 63, 71).

We could transpose the *Ford* decision into the topic of hostile takeovers. What role should a board play when a tender offer is made for the company, and should the answer depend on whether the corporation is conceived of as the property of the shareholders or as a social entity with responsibilities to more than just the shareholders? Not surprisingly, the adherents of the shareholder primacy model firmly believe that the board of directors is to adopt a passive approach, whenever the corporation is approached with an unsolicited takeover offer.[36] On the other hand, for those who believe that "the corporation is properly understood as a legal fiction representing the nexus of a set of contracts among the multiple factors of production provided by the organization's various constituencies,"[37] and that "shareholders are not inherently privileged relative to other corporate constituents,"[38] the board of directors remains in control and should not be a "passive instrumentality."[39]

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[36] *See* Frank H. Easterbrook and Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1980-1981) (arguing that resistance by a corporation's managers to premium tender offers ultimately decreases shareholder welfare).
[37] Stephen M. Bainbridge, *Unocal At 20: Director Primacy In Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 777 (2006).
[38] *Id.*
[39] *Unocal*, at 954.

A person can pick whichever side of the debate about the appropriate corporate organ that should have the ultimate control of a company, yet it wouldn't change the fact that it is the directors' duty to run the company on a day to day basis. According to one writer, "[I]t is not necessarily the providers of capital who are the masters, but rather those who have the free disposition of capital."[40] Corporation statutes have reflected this thinking by equipping the directors of a company with the powers to manage the affairs of the company.[41] Even the most die-hard proponents of the shareholder primacy model must realise the sheer nightmare it would be to have a large body of shareholders with diverse interests and experiences to manage the daily business of a company.[42]

Conceding that the shareholders have delegated the powers of control to the directors, what structures exist for the shareholders to check the exercise of the director's powers, and what assurance do the directors have to carry out their functions without continually looking over their shoulders? Enter the business judgment rule.

A. The Business Judgment Rule

The business judgment rule is a common law invention that is one part, a doctrine of judicial non-interference and the other part, a presumption in favour of directors that protects them from liability with respect to decisions taken in carrying out their duties. The 1924 case of *Robinson v. Pittsburgh Oil Refining Corporation*[43] was one of the earliest cases establishing the business judgment rule.[44] In that case, the plaintiffs contended that the directors negotiated a sale of all the assets of the corporation on terms

[40] *See* Thierry Kirat, *The firm between law and economics- An overview of selected legal-economic scholars of the past, in* THE FIRM AS AN ENTITY 131, 138 (quoting Ripert, 1951 [1947]: 17) (Yuri Biondi, Arnaldo Canziani & Thierry Kirat eds., Routledge 2007).
[41] *See* Bainbridge, *supra* note 37 at 778 n.44.
[42] *See* Bainbridge, *supra* note 37 at 782-84.
[43] 126 A. 46 (Del. Ch. 1924).
[44] *See also,* Davis v. Louisville Gas & Electric Co.**,** 16 Del.Ch. 157, 142 A. 654 (Del.Ch. 1928); Mercantile Trading Co. v. Rosenbaum Grain Corp., 17 Del.Ch. 325, 154 A. 457 (Del.Ch. 1931).

that were not in the best interests of the corporation. The court in its examination stated that the directors are clothed with a presumption that they act bona fide in the best interests of the corporation, and therefore the court's decision must turn on whether the terms of the sale were so unfair as to constitute a fraud. According to the court, "[w]hether or not others would agree that the directors displayed sound business judgment in rejecting the Hood offer . . . , it nevertheless cannot be said that their action was so unreasonable as to be removed entirely from the realm of the exercise of honest and sound business judgment . . . . Their judgment … should not be interfered with."[45]

The *Robinson* case set out the foundations of the business judgment rule as follows – there is a presumption that the directors of a company act in the best interest of the company; therefore, as long as their actions do not amount to fraud, the court will not interfere with the board's decision. The business judgment rule in a more recent case was stated as follows:

> In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of the directors will not be interfered with by the courts. The burden of showing the existence of bad faith or abuse of discretion rests upon the plaintiff who charges that the corporate action was taken to benefit the majority at the expense of the minority.[46]

Thus, the burden of proof is on the plaintiff to rebut the presumption by showing bad faith,[47] gross abuse of discretion,[48] fraud,[49] gross negligence[50] on the part of the board of directors.[51]

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[45] *Robinson*, 126 A.46 at 49-50.
[46] Warshaw v. Calhoun, 43 Del. Ch. 148, 157 (Del. 1966).
[47] *Id*.
[48] *Id.*
[49] *Robinson*, 126 A.46.
[50] Smith v. Van Gorkom, 488 A. 2d 858, 873 (Del. 1985).
[51] It should be noted here that DEL CODE ANN. TIT. 8, § 102(b) (7) (2010) allows companies to make provisions in their certificate of incorporation which eliminate or limit the personal liability of directors with respect to monetary damages for breach of fiduciary duty provided that the exclusion or limitation of liability does not apply to a breach of the duty of loyalty, or for acts or omissions in bad faith or for intentional misconduct or a knowing violation of law, or for any transaction for which the director derived an improper benefit. This

B. Business Judgment Rule by another Name?

Although the business judgment rule applied generally to all decisions of directors, the courts soon had to deal with a new set of facts which necessitated a recalibration of the essential elements of the business judgment rule. In the 1964 case of *Cheff v. Mathes*,[52] building on the foundation of a long line of cases,[53] the Supreme Court of Delaware distinguished those cases where the facts would shift the burden of proof to the defendant directors regardless of the presumption that directors ordinarily are acting in the best interest of the corporation, which ordinarily would have placed the burden of proof on the plaintiffs challenging the directors' decision. According to the court;

> We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult. Hence, in our opinion, *the burden should be on the directors to justify such a purchase as one primarily in the corporate interest.* [54]

The court recognised that directors cannot always be presumed to be acting in the best interest of the corporation, particularly when there is a threat to their control. One such scenario that presents a threat to director's control is a tender offer, otherwise known as a hostile takeover. In such instances, the directors necessarily face a conflict of interest[55] and it can no longer be vouchsafed that directors are acting primarily in the

provision applies chiefly to directors' breach of the duty of care. *See also*, Lyondell Chemical Co. v. Ryan, 970 A. 2d 235, 239 (Del. 2009).

[52] 199 A. 2d 548 (Del.1964).

[53] *See, e.g.*, Yasik v. Wachtel, 17 A.2d 309 (Del. Ch. 1941); Kors v. Carey , 158 A.2d 136 (Del. Ch. 1960); Bennett v. Propp, 187 A.2d 405 (Del. 1962).

[54] Cheff v. Mathes, *supra* note 52, at 554 (emphasis added) (citing its decision in Bennett v. Propp, *supra* note 53).

[55] Typically when a company is taken over, there is a restructuring which tends to cut the jobs of senior management including directors; faced with this situation therefore, directors' instinct would be to block the takeover which may (or may not) be beneficial to the corporate interest in order to protect their jobs. *See*, Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN L. REV. 819, 826 (1980-1981) (stating that "there is little question that management is subject to a conflict of interest when confronted with a proposal for the corporation's acquisition.) *See also*, Dynamics Corp. of Am. V. CTS Corp., 794 F.2d 250, 256 (7th Cir 1986), *rev'd on other grounds*, 481 U.S. 69 (1987).

corporate interest. It became necessary to challenge the status quo of directors, and the court's solution was to shift the burden of proof to the directors in conflict of interest/ change of control situations. In discharging this burden, the directors had the onus of proving that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed as a result of the proposed change of control, and this required a showing of good faith and reasonable investigation.[56] The defendant directors in *Cheff* discharged this burden "based upon direct investigation, receipt of professional advice, and personal observations of the contradictory action of Maremont and his explanation of corporate purpose," which led to a justifiable conclusion that there was a reasonable threat to the continued existence of the company at least in its then present form.[57]

Although largely a purpose-driven standard i.e. directors had to show that maintaining control of the corporation was not the primary purpose of resisting the potential takeover, the case also set in motion the process-driven test that was to become a *sine qua non* after the decision in *Unocal*.[58] Seminal as it were, the critics had plenty to say – mostly that the primary purpose test of *Cheff* almost always ended up as an application of the business judgment rule.[59]

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[56] *Cheff*, 199 A. 2d at 555.

[57] *Id.*, at 556. The court went on to list those elements that convinced it that the directors of Holland had acted in good faith and reasonable investigation including,

> (1) Maremont had deceived Cheff as to his original intentions, since his open market purchases were contemporaneous with his disclaimer of interest in Holland; (2) Maremont had given Cheff some reason to believe that he intended to eliminate the retail sales force of Holland; (3) Maremont demanded a place on the board; (4) Maremont substantially increased his purchases after having been refused a place on the board; (5) the directors had good reason to believe that unrest among key employees had been engendered by the Maremont threat; (6) the board had received advice from Dun and Bradstreet indicating the past liquidation or quick sale activities of Motor Products; (7) the board had received professional advice from the firm of Merril Lynch, Fenner & Beane, who recommended that the purchase from Motor Products be carried out; (8) the board had received competent advice that the corporation was over-capitalized; (9) Staal and Cheff had made informal personal investigations from contacts in the business and financial community and had reported to the board of the alleged poor reputation of Maremont.

[58] This can be seen from the way the court harped on the steps the board had taken in showing that they acted with good faith and reasonable investigation.

[59] *See* Ronald J. Gilson and Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 249 (1988-1989) (stating that the *Cheff* test had

Outside of Delaware, the courts also recognised the problem with applying the business judgment rule to conflict of interest situations. Their resolution of this conflict was also to shift the burden of proof to the directors, but rather than justifying the defensive measure as being primarily in the corporate interest, the directors' burden was to prove that "the transaction was fair and reasonable to the corporation."[60] The key difference between these two approaches was that while *Cheff* automatically shifted the burden of proof to the directors in a control situation, the "fair and reasonable" standard adopted by the federal courts required the plaintiffs first to prove that the directors "had an interest in the transaction, or acted in bad faith or for some improper purpose."[61]

Neither of these solutions satisfied the camp that would always be dissatisfied with any decision that allowed directors to prevent the takeover of the corporations they oversee.[62] With the increased hostile takeover activity in the United States in the 1980s, it was only a question of time before the Delaware courts would have to devise new approaches to handling the conflict of interest situations necessarily brought about by hostile takeovers.

been reduced to "a routine application of the business judgment standard," because takeover defense lawyers could always conjure a purpose for the defensive measure that would pass muster.)

[60] Treadway Companies, Inc. v. Care Corp. 638 F.2d 357, 382 (2nd Cir. 1980).

[61] *Id.*

[62] *See, e.g.*, Easterbrook and Fischel, *supra* note 36.

A. Events leading up to Unocal

From about the late 1970s, corporate America began to see a rash of takeover activity that extended well into the 1980s.[63] With this increased takeover activity evolved new and sophisticated techniques for achieving the potential acquirer's objective, including the now infamous coercive two-tier tender offer.[64] Target companies found themselves susceptible to these unsolicited offers, and had to respond innovatively to these challenges, helped along by their advisers including attorneys such as Martin Lipton.[65] One of such potential takeover attempts i.e. Mesa Petroleum Co.'s attempted takeover of Unocal Corp., employing the two-tier tender offer format, gave rise to a whole new jurisprudence of corporate law in Delaware and beyond.

In analysing the *Unocal* decision, it is important to keep in mind the tensions between the shareholder primacy and the stakeholder conceptions of the corporation, discussed earlier in Part II of this paper. This was a time when the battle between the two camps was raging and the hostile takeover battles presented an arena for the proponents of each side of the argument to advance their theories. For good or bad, the courts were drawn into the fray, with the weight of resolving such topical socio-economic policy issues thrust upon them. [66] As Justice Moore (one of the three justices on the Delaware Supreme Court to hear the *Unocal* case) would later admit, the Delaware Supreme Court's

[63] *See* Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 101n.1 and accompanying text (1979-80). For a brief history of takeover activity during this period, *see*, Andrew G.T. Moore II, *The Birth of Unocal – A Brief History*, 31 DELAWARE JOURNAL OF CORPORATE LAW, 865 (2006).
[64] Moore II, *supra* note 63, at 868. In the two-tier tender offer, the bidder made a bid for a majority of the shares of the company payable in cash, with the second step being the acquisition of the balance of the shares using subordinated debt or "junk bonds." The effect of this type of offer was to stampede the shareholders to tender into the first tier of the offer, as they feared receiving the short end of the stick by the second offer.
[65] Martin Lipton, a partner in the New York law firm of Wachtell, Lipton, Rosen & Katz, was one of the staunchest supporters and proponents of a target board's right to defend the company against unsolicited tender offers.
[66] *See* Moore II, *supra* note 63, at 872.

position was made more challenging by the fact that there was no well-established precedent for it to follow in deciding the distinctive issues presented in *Unocal*.[67]

B. Unocal

Unocal Corp. v. Mesa Petroleum Co.,[68] was an appeal to the Delaware Supreme Court from a preliminary injunction granted by the Chancery Court, enjoining the decision of the directors of Unocal Corp. to carry out a self-tender offer as a defence to Mesa Petroleum's tender offer. The facts of the case presented a novel issue before the Delaware court – the validity of a target company's discriminatory self-tender offer. [69]

Setting off from the standard in *Cheff*, the court concluded that to succeed a legal challenge, a defensive measure to frustrate an unsolicited takeover bid must be motivated by the best interest of the corporation and its stockholders.[70] The court went on however to inquire into the additional aspect of "balance". Accordingly, "if a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed."[71] This further element of balance is what is now described as the proportionality test.

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[67] *See* Moore II, *supra* note 63, at 873. I do not accede to the point made by Justice Moore that there was no well-established precedent in deciding this case. While the particular defensive measure (i.e. the discriminatory self-tender offer) may have been ground-breaking, the fact remains that it was just another defensive measure. The courts had had to resolve disputes around defensive measures in the past, and there was clear precedent for resolving control issues leading to conflict of interest re *Cheff*. It may be that the court saw the facts of this case as presenting an opportunity to mollify the property conception enthusiasts by appearing to impose a stricter standard that would appear to deter target boards from adopting defensive measures. What is even more puzzling is the fact that the Supreme Court's decision in *Unocal* had the same result as previous precedent had established – i.e. directors could unilaterally, i.e. without shareholder approval, adopt defensive measures in the face of a hostile takeover.

[68] 493 A.2d 946 (Del. 1985).

[69] The discriminatory self-tender offer was a new defensive measure previously undecided by the Delaware courts. Other more common defensive measures included greenmail, anti-trust actions, acquisitions, etc. which had all been brought before various courts. The Rights Plan or the "poison pill," as it is colloquially known, the innovative defensive measure designed by Martin Lipton would be tested for the first time in Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985), a case decided in the same year as *Unocal*.

[70] *Unocal*, at 955. This is the first prong of Unocal, which was simply a restatement of the rule in *Cheff*. According to the court, this burden is satisfied by showing "good faith and reasonable investigation", and such proof is substantially enhanced where the decision to adopt the defensive measure is approved by a board comprised of a majority of outside, independent directors.

[71] *Id.*

C. Achieving Balance

Upon averring that the examination of whether a defensive measure is reasonable in relation to the threat involves an analysis of the form of the takeover bid and its effect on the corporate enterprise, the court provided no further guidance on how to proceed with evaluating the threat against the response, save to state that,

> in adopting the selective exchange offer, the board stated that its objective was either to defeat the inadequate . . . offer, or should the offer still succeed, provide the 49% of its stockholders, who would otherwise be forced to accept "junk bonds", with $72 worth of senior debt. We find that both *purposes* are valid. [72]

The court declared its satisfaction with the discharge of the reasonableness or proportionality test upon this basis. In introducing the concept of proportionality, a concept which had no precedent in corporate law jurisprudence,[73] it appears that the court may not have given thorough consideration to its elements.[74] This is immediately apparent when the court could not provide any principles for determining proportionality. It was not until later cases that the court began to shed more light on the elements of proportionality.[75]

One issue that comes to mind in the court's decision is the extent to which a purpose-driven test remains relevant post-*Cheff*. The *Cheff* standard was heavily criticised because the primary purpose test required an analysis of management's motives. As one critic put it, management could always conjure up a policy conflict, which would satisfy the court's inquiry into whether self-interest was the primary purpose of the particular transaction.[76] The Unocal standard, it is presumed, was supposed to improve on the *Cheff* standard; yet here we

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[72] *Unocal*, at 956 (emphasis added).

[73] Ostensibly realising this, the court remarked that corporate law is not static and must continue to rise to the challenges of new developments, *see Cheff*, at 957.

[74] It is either that, or the court was guided by some other available standard of proportionality.

[75] *See* Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995) (in which the court, articulating snippets of Delaware case law developed in the years since *Unocal*, concluded that the reasonableness of a defensive measure is determined by two factors. The first is whether the measure is draconian i.e. by being preclusive or coercive; or secondly, whether the measure falls within a range of reasonable responses to the threat posed by the takeover offer).

[76] *See generally*, Gilson and Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, *supra* note 5, at 249; Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, *supra* note 55, at 828.

are, again looking to the purpose of the defensive measure. In fact, a case can be made that the purpose inquiry in *Unocal* was of a lesser standard than in *Cheff*. While pronouncing on the reasonableness of the discriminatory self-tender offer as a response to the bidder's coercive two-tier offer, the court considered the purposes of the response and found them to be *valid*. The word "valid" is defined as "sound; just; well-founded,"[77] while "primary" means "first or highest in rank or importance; chief; principal."[78] Clearly, the *Cheff* primary purpose standard imposes a higher burden of proof on the directors than the valid purpose standard the court applied in *Unocal*. Under Unocal, any sound purpose would suffice, while Cheff required that the interest of the corporation had to be front and centre.

To summarise, the *Unocal* court while attempting to impose an enhanced standard of scrutiny in change of control situations leading to a conflict of interest, introduced the element of proportionality which in that particular case was satisfied by showing that the defensive measure had a valid purpose. While I concede that the Delaware Supreme Court has recovered from this initial misstep and revamped the proportionality test over the years,[79] with a stricter interpretation at least theoretically, the *Unocal* decision offers an insight into the mind of the court at the time, which is that it remained unchanged in its view that directors are entitled to the protection of the business judgment rule even with the "omnipresent spectre that the board may be acting primarily in its own interests." I conclude therefore that the Delaware Supreme Court while appearing to move towards the centre in its *Unocal* decision, still landed firmly in the camp of the stakeholder and director primacy theories of the corporation. My conclusion is supported by the court's statement in that case that the directors could consider the impact of a potential takeover on other "constituencies"

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77 DICTIONARY.COM, www.dictionary.reference.com (last visited Jan. 22, 2012).
78 *Id*.
79 See *supra* note 75, and the accompanying text.

apart from shareholders.[80] When looked at in this way, it is hard to fault the critics that think of the Unocal standard as simply the business judgment rule, by another name.[81]

This analysis will not be complete without an evaluation of the proportionality test against similar standards developed in other areas of law.

[80] *Unocal*, at 955.

[81] The Unocal standard has often been referred to as a "dressed up" business judgment rule. *See* Bradley R. Aronstam, *The Interplay of Blasius and Unocal – A Compelling Problem Justifying the Call for Substantial Change*, 81 OR. L. REV. 429 (2002) (stating that commentators agree that Unocal has been watered down to a dressed-up business judgment).

A. Proportionality and Constitutional Law

1. Equal Protection and the Rational Basis Test

The Fourteenth Amendment[82] to the United States Constitution provides in part that, "[n]o State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." The latter part of the clause is widely known as the "equal protection clause," and serves to protect persons within the jurisdiction of the U.S. from legislative and executive discrimination.

The Fourteenth Amendment is instructive because of the body of jurisprudence that has developed around the analysis of the equal protection provision. There are three levels of scrutiny applicable in analysing equal protection claims[83]: the rational basis test,[84] intermediate scrutiny,[85] and strict scrutiny.[86] These levels of scrutiny apply by examining the fit between the means and ends of a governmental action.

[82] The proposed amendment was sent to the states June 16, 1866, by the Thirty-ninth Congress. It was ratified July 9, 1868. Although the Fourteenth Amendment applies to the states and not the federal government, the U.S. Supreme Court in Bolling v. Sharpe, 347 U.S. 497 (1954), held that equal protection applies to the federal government through the due process clause of the Fifth Amendment; *see* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW PRINCIPLES AND POLICIES 685 (4th ed., Wolters Kluwer Law & Business 2011).
[83] For a discussion of the tiered approach under the equal protection analysis including its history and criticisms, see, 1 WILLIAM J. RICH, MODERN CONSTITUTIONAL LAW 412(3rd ed., Thomson Reuters 2011).
[84] See discussion *infra* page 23 below, and Part V-A.2 of this paper.
[85] "Under intermediate scrutiny, a law will be upheld if it is *substantially related to an important government purpose*. In other words, the government's objective must be more than just a legitimate goal for government to pursue; the court must regard the purpose as "important." The means chosen must be more than a reasonable way of attaining the end; the court must believe that the law is substantially related to achieving the goal." (Emphasis added). CHEMERINSKY, *supra* note 82, at 553.
[86] "Under strict scrutiny, a law will be upheld if it is *necessary to achieve a compelling government purpose*. In other words, the court must regard the government's purpose as vital, as "compelling." Also, the law must be shown to be "necessary" as a means to accomplishing the end." (Emphasis added). CHEMERINSKY, *supra* note 82, at 554.

Most relevant for our purpose is the rational basis test.[87] The U.S. Supreme Court has framed the rational basis test in different ways; in *Lindsley v. Natural Carbonic Gas Co.*, the Court declared, "[w]hen the classification in such a law if called in question, if any state of facts reasonably can be conceived that would sustain it, the existence of that state of facts at the time the law was enacted must be assumed …. One who assails the classification in such a law must carry the burden of showing that it does not rest upon any reasonable basis, but is essentially arbitrary."[88] In *Royster Guano Co. v. Virginia*, the Court said, "[T]he classification must be reasonable, not arbitrary and must rest upon some ground of difference having a fair and substantial relation to the object of the legislation, so that all persons similarly situated shall be treated alike."[89] In *City of New Orleans v. Dukes*, the Court formulated the test by stating that the classification must be "rationally related to a legitimate state interest" to survive a challenge.[90]

To encapsulate,

> Under the rational basis test, a law will be upheld if it is *rationally related to a legitimate government purpose*. In other words, the government's objective only need be a goal that is legitimate for government to pursue. In fact, the goal need not be the actual purpose of the litigation, but, rather, *any conceivable legitimate purpose is sufficient*. The means chosen need only be a reasonable way to accomplish the objective.[91]

2. Elements of the Rational Basis Test

a. Presumption/ Burden of Proof

In *Hodel v. Indiana*, with respect to the particular legislation being challenged, the Court stated that "[S]uch legislation carries with it a presumption of rationality that can only be overcome by a clear showing of arbitrariness and irrationality."[92] In *City of New Orleans*,

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[87] For a detailed reading of the different levels of scrutiny, *see* Russell W. Galloway, *Means-End Scrutiny in American Constitutional Law*, 21 LOY. L.A. L. REV. 449 (1988).
[88] 220 U.S. 61, 78-79 (1911).
[89] 253 U.S. 412, 415 (1920).
[90] 427 U.S. 297, 303 (1976).
[91] CHEMERINSKY, *supra*, note 82, at 552 (emphasis added).
[92] 452 U.S. 314, 331-332 (1981).

the Court stated that "our decisions presume the constitutionality of the statutory discriminations."[93] As a result of this presumption, the burden of proof devolves on the challenger of the legislation to rebut the presumption by showing that the law in question serves no legitimate purpose, or that enactment or enforcement of the law bears no reasonable relation to the government's purpose.

Already, one similarity between the rational basis test and the business judgment is clear - there is like in the rational basis test, a presumption that directors are acting in the best interest of the corporation and its shareholders, absent a showing of bad faith or gross abuse of discretion.

b. Rationally or Reasonably Related

Although the common appellation for this level of scrutiny is "rational basis test," a reading of the Court's decisions shows the frequency with which the courts switch between the words "reasonable" and "rational" such that the test could also be termed the "reasonable basis test." In fact, an incursion into the dictionary meaning of the word "rational" which is defined as "agreeable to reason; reasonable; sensible"[94] shows why this is so – the word "rational" essentially means "reasonable." Whichever way the term is framed, the court's duty is to decide whether the law in question is reasonably related to a legitimate purpose of government.[95]

Since the government need only establish that facts exist which can serve as a rational basis for belief that the measure would properly serve a legitimate interest,[96] a plaintiff would need to establish that the government measure in question is not a rational or reasonable method of achieving its objectives by showing that the government's action is

93 *Supra* note 90.
94 DICTIONARY.COM, www.dictionary.com.
95 Ravin v. State of Alaska, 537 P.2d 494 (Sp. Ct. Alaska 1975).
96 *Id.*

"clearly wrong, a display of arbitrary power, not an exercise of judgment."[97] This is tough to pull off as the court "requires a showing that by no reasonable possibility, can the challenged legislation fall within the wide range of discretion permitted to Congress."[98] It is obvious from the foregoing why the "rational basis test" is said to be the most deferential level of scrutiny applied by the courts.[99]

c. Legitimate Purpose

Generally, the courts will hold that the government has a legitimate purpose when it carries out its established functions. Chief among those functions is its "police" role i.e. protecting its citizens.[100] The implicit corollary of this is that the government has the duty to protect its citizens, in whichever way it thinks best and whether or not the citizens agree with its methods. While protecting public safety, health or morals of the public, has been held to be a legitimate purpose, "virtually any goal that is not forbidden by the Constitution will be deemed sufficient to meet the rational basis test."[101]

B. Comparison of the levels of scrutiny of director actions to the levels of scrutiny under Constitutional Law

Just as with the different level of review under constitutional law, courts in Delaware adjudicating corporate law issues apply different standards of review depending on the facts of a particular case. The gradation of the standards of scrutiny in Delaware courts is as follows: first, there is the default and the most deferential standard of review which is the business judgment rule discussed in Part III.A of this paper. Next, where there is the omnipresent spectre of self-interest in change of control situations, the

[97] Helvering v. Davis, 301 U.S. 619, 640 (1937).
[98] U.S. v. Butler, 297 U.S. 1, 67 (1936).
[99] *See* City of Dallas v. Stanglin, 490 U.S. 19, 26 (1989) (stating that rational basis scrutiny "is the most relaxed and tolerant form of judicial scrutiny under the Equal Protection Clause".)
[100] CHEMERINSKY, *supra* note 82, at 697 (stating that "[a]t the least, the government has a legitimate purpose if it advances a traditional "police" purpose: protecting safety, public health, or public morals.")
[101] CHEMERINSKY, *supra* note 82, at 698. However, this is not to say that every government purpose survives the rational basis test; the Supreme Court has declare certain laws unconstitutional for lacking a legitimate purpose. *See, e.g.*, U.S. Department of Agriculture v. Moreno, 413 U.S. 528 (1973); Metropolitan Life Insurance Co. v. Ward, 470 U.S. 869 (1985); Williams v. Vermont, 472 U.S. 14 (1985).

courts will apply the enhanced intermediate Unocal standard of review. A third, and the highest standard of review is the entire fairness standard, applicable where a party (in this case, the directors or a majority shareholder) stands on both sides of a transaction; such party has the burden of establishing the entire fairness of the transaction.[102]

Because constitutional law informs the development of the common law in other aspects of law, it will be helpful at this point to match the reasonableness provisions of the Unocal standard against the different levels of judicial scrutiny under the Constitution's Equal Protection Clause. Intuitively, the natural place to start is to compare like for like i.e. as Unocal is the intermediate standard of review under Delaware corporate law, it would be logical to inquire into the similarities between it and the intermediate level of judicial scrutiny under the Equal Protection Clause.[103] That inquiry fails quickly as the intermediate level of scrutiny under constitutional law requires a showing that a measure is "substantially related" to an "important" government purpose, while Unocal requires a showing that a defensive measure is "reasonably related" to a "valid" corporate purpose. In qualifying the purpose, the words "valid" and "important" bear differing weights. A valid purpose is one which is "based on truth or reason; able to be accepted,"[104] while an important purpose is one which is "necessary or of great value."[105] Thus, a valid purpose is less compelling than an important purpose. Likewise, the "reasonably related" requirement is a less stringent standard than the "substantially related" standard.

Absent a convincing match between the two intermediate standards, the next step is to examine the wording of both the deferential rational basis and the enhanced strict scrutiny tests under constitutional law, and arrive at a conclusion as to which level of

[102] Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).
[103] See note 85, and the accompanying text.
[104] CAMBRIDGE DICTIONARIES ONLINE, www.dictionary.cambridge.org (last visited Jan. 22, 2012).
[105] *Id.*

scrutiny bears the closer resemblance to the Unocal standard; the conclusion is that the rational basis test is a better match. There are sufficient similarities between the rational basis test and the Unocal test to come to a conclusion that the Unocal test is modelled after, or at least bears the most significant relationship with the rational basis test.

First, both standards hang on a "reasonably related" requirement. On this point, I must note that while the Supreme Court considers "reasonableness" and "rationality" as implying the same standard of review, Delaware courts ascribe a higher standard to "reasonableness" than to "rationality."[106] Nonetheless, we will see that the elements of the "rationally/reasonably related" standard under the Supreme Court's judicial scrutiny are identical to the "reasonably related" test later developed by Delaware courts subsequent to *Unocal*.[107] In essence, on this point, application of the "reasonably related" test under both standards connotes the same result.

Further, the rational basis test requires the measure in question to be rationally (or reasonably) related to a "legitimate purpose," while the Unocal test requires a defensive measure to be reasonably related to a "valid purpose". The word "legitimate" is defined as "reasonable and acceptable,"[108] and as stated earlier, "valid" means "able to be accepted",[109] in other words "acceptable." On this basis therefore, the standard against which the purpose of a measure is assessed under the rational basis test and the Unocal test is the same i.e., an acceptable purpose will suffice. What constitutes an acceptable purpose? As discussed earlier,[110] any governmental law or action that serves a protective purpose is an acceptable purpose. In that same respect, directors' "duty of care extends to

[106] *See*, In re Toys "R" Us, Inc. Shareholder Litigation, 877 A.2d 975, 1000 (Del. Ch. 2005) (where the court stated that "courts would subject directors … to a heightened standard of reasonableness review, rather than the laxer standard of rationality review applicable under the business judgment rule."). Still, the difference between rational and reasonable review is not obvious from a purely semantic point of view.
[107] *See supra* note 75, and the accompanying text.
[108] CAMBRIDGE DICTIONARIES ONLINE, www.dictionary.cambridge.org (last visited Jan. 22, 2012).
[109] *Supra* note 104.
[110] *See supra* note 100, and the accompanying text.

protecting the corporation and its owners from perceived harm ….”[111] While the duty of protecting the society or corporation and its members is not the exclusive governmental or management function which is subject to a reasonableness analysis, it is one of their core purposes and it is probably for this reason that the courts have decided to apply a deferential level of scrutiny to any laws or actions that further this purpose.

Having reconciled the major elements of the constitutional rational basis test and the Unocal reasonableness test, it must be said that there is however one major distinction between both standards of review, which may be the sole support for any notion that the Delaware Supreme Court never intended the Unocal test to be a deferential standard, similar to the rational basis test. This distinction is the allocation of the burden of proof. The Supreme Court has made it quite clear that based on the presumption in favour of the government, the initial burden of proof falls on the party challenging the governmental action as being unreasonably related to the stated purpose.[112] On the contrary, Unocal recognises no such presumption, thereby shifting the burden of proof which was on the plaintiff under the business judgment rule to the defendant directors under the Unocal standard. It is only after the directors have discharged this initial burden of proof that they become entitled to the protection of the business judgment rule and the underlying presumption.

Allocating and re-allocating the burden of proof between parties is sometimes used to achieve a practical objective.[113] In this case, by recognising that the board of directors' motives in adopting defensive measures in a change of control situation might be unrelated to the welfare of the corporation or its shareholders, the *Unocal* court

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[111] *Unocal*, at 955 (emphasis added).
[112] This burden of proof does not shift. *But see*, Russell L. Galloway, *Means-End Scrutiny in American Constitutional Law* 21 LOY. L.A. L. REV. 449, 452 (1988) (stating that in a non-deferential rational basis test, it is not always certain where the burden of proof lies, and the government has been known to bear the burden of proof in some instances).
[113] CHRISTOPHER B. MULLER & LAIRD C. KIRKPATRICK, EVIDENCE 105 (4th ed., Aspen 2009).

resolved that a “new intermediate standard” was required in adjudicating such actions.[114] The outcome of this intermediate standard was the re-allocation of the burden of proof to the defendant directors who had to prove not only that they had reasonable grounds for believing that there was a threat to corporate policy and effectiveness, but that the defensive measure employed in response was reasonable in relation to the threat i.e. proportional.

My conclusion from the above discussion is that the Delaware Supreme Court in developing the intermediate Unocal standard certainly intended to scrutinise directors’ actions in change of control situations more thoroughly, because of the potential for conflict of interests. In order to scrutinise directors’ actions therefore, the court had to deny directors the automatic presumption applicable under the business judgment rule, and imposed the burden of proof in these situations on the directors. Even so, my impression is that the Delaware Supreme Court crafted this resolution from the standpoint of sympathisers of the stakeholder theory of the corporation, resolute in the view that the directors of a company are not only entitled to deference, but are also allowed to consider constituencies other than shareholders in deciding the future of a company.[115]

Otherwise, I find it hard to accept that the justices of the Delaware Supreme Court, who are presumably students of constitutional law, missed the relationship between the so-called intermediate standard of Unocal, and the highly deferential rational basis test under constitutional law. If the court had indeed intended a genuine intermediate test, it could have looked to constitutional law for guidance and adopted a “substantially related” test rather than the watery “reasonably related” standard. With hindsight, it is not surprising that the Delaware Supreme Court is yet to strike down a defensive measure on the basis of the Unocal

[114] *See* Moore II, *supra* note 63, at 883.
[115] *Unocal*, at 955.

reasonableness standard[116]; after all even in constitutional law cases, it is very rare for the Supreme Court to hold that a law or governmental action fails the rational basis test.[117]

C. Proportionality and Torts Law

In the torts of assault and battery, a defendant may have a defence based on the use of reasonable force in the defence of himself or others, or his property, as long as he reasonably believes that he was required to use force in response to a threat which he faces.[118] Regardless, the defence does not grant carte blanche to any person to use force indiscriminately in defending himself; rather, proportionality is central to such defence. In this instance, proportionality hinges on the following elements: the interest the defendant is protecting, the injury or harm threatened by the attacker, and in some instances any other alternatives that may have been available to the defendant.[119] The court does not make this determination in a vacuum; society values certain interests higher than others, and the law weighs different types of injuries differently. So, there is essentially a match-up between certain interests and the types of harm which threaten these interests on the one hand, and the type of force that is acceptable in protecting the interests from harm on the other hand. The use of excessive force may subject the defendant to liability, albeit for the excess only.

In *Slayton v. McDonald*,[120] a case in which the defendant a 14 year old school boy shot another 14 year old in the leg, the court found in favour of the defendant. In the case, the plaintiff who was a bigger child than the defendant had threatened to harm the defendant and actually followed the defendant into his home, purportedly to carry out the threat. The defendant then armed himself with a gun and asked the plaintiff to leave, to which the plaintiff refused. When the plaintiff continued to advance towards the defendant, the

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[116] Robert B. Thompson and D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 284 nn. 112-14 (2001-2002).
[117] CHEMERINSKY, *supra* note 82, at 706.
[118] 1 DAN B. DOBBS, PAUL T. HAYDEN & ELLEN M. BUBLICK, THE LAW OF TORTS, 242 (2nd ed., West 2011).
[119] ARTHUR BEST & DAVID W. BARNES, BASIC TORT LAW: CASES, STATUTES AND PROBLEMS 59 (3rd ed., Aspen 2010).
[120] 690 So. 2d 914 (La. Ct. App. 1997).

defendant shot him in the leg. The appellate court agreed with the trial court that the defendant pulled the trigger in order to "stop the plaintiff's advance," that the defendant reasonably perceived a threat of harm from the plaintiff and was therefore justified in shooting the plaintiff, even though the plaintiff was unarmed.

On the other hand, in *Young v. Warren*[121] where the defendant shot and killed Lewis Young in the defence of the defendant's daughter, the court found that there was no evidence that the defendant's daughter was at the time of the shooting, in danger of death or serious bodily harm. This is because even though Lewis Young had earlier threatened the defendant's daughter, at the time of the shooting he had left the defendant's daughter's house. Also, the defendant shot Lewis Young in the back at close range when it was apparent that Lewis Young had removed himself from the threatening situation to the defendant's daughter. The court held that the defence of self-defence will not be upheld where more force than is necessary or reasonable is used.

On a reading of the above cases, deadly force may be deployed to prevent serious bodily harm, while moderate or reasonable force may be used in fending off mere assault or battery.[122] The test for determining the defendant's perception of threat is the objective reasonable man's test; i.e., would a reasonable person in the defendant's shoes perceive reasonable harm in the same circumstances? The courts in applying the reasonable man's test would consider the facts that were actually known to the defendant at the time he acted to defend himself. In essence, while the overt facts at the time of the self-defence would not ordinarily support a reasonable man acting in self-defence, the courts would consider other facts which the defendant had known about the attacker and the situation which would justify the defendant acting in self-defence even where a reasonable man without the benefit of

[121] 383 S.E.2d 381 (N.C. Ct. App. 1989).
[122] BEST & BARNES *supra* note 119, at 64.

having those facts, would have acted differently.[123] Therefore, "applying this rule, cases have held that if the defendant knows that his attacker has violent propensities, or if he has been hostile to the defendant in the past, he may reasonably perceive an attack, even though bystanders who have no such information would not recognise the need for defense."[124]

The final piece of the puzzle in proportionality and torts law is the allocation of the burden of proof – here, self-defence is an affirmative defence in tort law which requires the defendant to prove the elements required to succeed in a defence of self-defence.[125]

How then does proportionality in torts law compare with proportionality under Unocal? For one, tort law has succeeded where Unocal has not i.e. it has created a match-up between the threat and the response. To put it clearly, deadly force is to be used for threats of serious bodily harm while moderate force is to be used for threats of assault and battery. Unfortunately, the Delaware Supreme Court has been unable or unwilling to create this match up in deciding the reasonably related defensive measures for tender offers. Chancellor Allen's attempt in *City Capital Associates Partnership v. Interco* to classify inadequate value (of the tender offer) as a lesser threat which was "far too mild" for the board to respond by leaving its poison pill in place indefinitely,[126] was shot down by the Delaware Supreme Court in *Paramount Communications, Inc. v. Time, Inc*. when it said that making a determination regarding inadequate value would involve the court substituting its judgment for that of the board of directors.[127] While this may have been an appropriate holding in the circumstances, the Delaware Supreme Court missed an opportunity to state categorically whether inadequate value is a serious or a mild threat, and whether leaving a poison pill in place indefinitely is an extreme or reasonable form of defence to the threat of inadequate value.

[123] DOBBS ET. AL., *supra* note 118, at 248-249.
[124] *Id.* at 249.
[125] *Id.* at 245.
[126] 551 A.2d 787, 798 (Del. Ch. 1988).
[127] 571 A.2d 1140, 1153 (Del. 1989).

Other than the above, there are similarities between proportionality in self-defence and proportionality under Unocal. For one, the burden of proof in both instances rests with the defendant who has to prove that it reasonably believed that there was a threat, and that the response to the threat was proportionally related. In addition, regarding substantive coercion as discussed in Part VI.A. below, where the court accepts that there may be facts which are solely within the board's knowledge which cause it to defend the company against a hostile takeover, in torts law as well, self-defence will be upheld where there were certain facts known to the defendant which if a reasonable man had known, would likely have reacted in the same way.

D. Proportionality and Criminal Law

Self-defence under criminal law is basically derived from statute, with the criminal statutes applying to civil cases sometimes, and vice-versa.[128] For instance, the Model Penal Code on which several State criminal statutes are modelled[129] provides that, "[T]he use of force upon or toward another person is justifiable when the actor believes that such force is immediately necessary for the purpose of protecting himself against the use of unlawful force by such other person on the present occasion."[130] Although the Explanatory Note to that section states that the defendant's "actual belief" in the necessity of using force and not necessarily "reasonable belief" as seen in Torts Law is sufficient to sustain the defence, [131] in *United States v. Peterson*, the Court of Appeals, District of Columbia Circuit stated that,

> [N]ecessity is the pervasive theme of the well-defined conditions which the law imposes on the right to kill or maim in self-defence…. The defender must have believed that he was in imminent peril of death or serious bodily harm, and that his response was necessary to save himself therefrom. *These beliefs must not only have been honestly entertained, but also objectively reasonable in light of the surrounding circumstances*." [132]

[128] DOBBS ET. AL., *supra* note 118, at 244.
[129] *See, e.g.*, 18 Pa. Cons. Stat. Ann. § 505 (West).
[130] § 3.04. Use of Force in Self-Protection., Model Penal Code § 3.04.
[131] § 3.04. Use of Force in Self-Protection., Model Penal Code § 3.04. If however, the belief was mistaken or recklessly formed, the defendant may be charged with recklessness or negligence.
[132] 483 F.2d 1222, 1229-1230 (D.C. Cir. 1973) (emphasis added).

While there is no direct proportionality requirement in the use of self-defence in criminal law requiring an evaluation of the threat against the force used, the use of deadly force is restricted to situations where "the actor believes that such force is necessary to protect himself against death, serious bodily injury, kidnapping or sexual intercourse compelled by force or threat …."[133] Once again, we see that there is a match-up between the extreme response of deadly force and the serious threats of death and serious bodily injury. With regard to the burden of proof, except for a few States which place the burden of proof of self-defence on the defendant and which may be discharged by a preponderance of evidence,[134] the general rule is that the prosecution's burden of proving the crime beyond reasonable doubt includes the burden of proving the absence of self-defence beyond reasonable doubt.[135]

[133] § 3.04. Use of Force in Self-Protection., Model Penal Code § 3.04.
[134] WAYNE R. LAFAVE, MODERN CRIMINAL LAW: CASES COMMENTS AND QUESTIONS 499 (4th ed., Thomson/West 2006).
[135] *See, e.g.*, U.S. v. Peterson, *supra* note 132, at 1230.

PART VI DEVELOPMENT OF THE UNOCAL PROPORTIONALITY TEST THROUGH THE CASES

A. Threats to a Corporation

As mentioned earlier, Unocal sets out two criteria which a board of directors must satisfy in order to justify a defensive measure in response to a potential takeover: the first is that the directors must determine that the tender offer poses a threat to corporate policy and effectiveness, and the second is that the defensive measure must be reasonable in relation to the threat posed by the tender offer. Thus a discussion of the proportionality requirement will not be complete without an analysis of what constitutes a threat.

Gilson and Kraakman did a thorough job in their 1989 article,[136] in which they identified a "typology" of threats, which courts up until that point had alluded to in their rulings. They are:

(i) "Opportunity loss" – i.e. by tendering into a hostile offer, the shareholders of the target company lose any chance of deriving increased benefits which could be generated by present management;

(ii) "Structural coercion" – i.e. the prospect that shareholders will be treated differently in a takeover offer subsequent to the initial tender offer, could force shareholders to take adverse decisions, or lead to a bandwagon effect in which everyone tenders into the initial tender offer;

(iii) "Substantive coercion" – i.e. shareholders would tend to accept the tenderer's inadequate offer due to their mistaken or ignorant belief about the value of their company.

The above compilation of the spectrum of threats, while it may have provided an accurate description of the possible threats, and a reference point for Delaware courts in the

[136] Gilson and Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review*, 44 BUS. LAW. 247, 267 (1988-1989).

days following,[137] is only a part of the whole picture. A plain reading of this typology of threats appears as though to limit acceptable threats solely to threats to the shareholders. It is unlikely however that this is what the Delaware Supreme Court intended in *Unocal*. To reiterate the holding in that case, the court stated that in analysing a takeover bid, directors may consider "the impact on "constituencies" other than shareholders."[138] Subsequently in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, the court said that directors may consider constituencies other than shareholders in analysing takeover bids, "provided there are rationally related benefits accruing to the shareholders."[139] Some commentators would interpret this to mean that shareholder interests are foremost[140]; however the clear language of the court does not suggest this. A different interpretation of the court's statement is that whatever other interests are being considered, shareholder interests must always be given due consideration; essentially, shareholder interests must not be ignored while giving consideration to other stakeholders.

Pointedly, recent and not-so-recent developments have overtaken the era of the typology of threats, and the typology of threats does not reflect current case law on the types of acceptable threats, for which a board may impose defensive measures. In fairness to the Gilson & Kraakman article, the available body of case law in the Delaware Chancery at the time pointed to the inference that shareholder interests were paramount in considering tender offers. On this basis, certain defensive measures had been found to be unreasonable for interfering with shareholders' rights. A brief summary of those cases in which the courts, in this case the Delaware Chancery, found defensive measures to be unreasonable for interfering with shareholder choice (i.e. coercive) are as follows:

[137] *See, e.g.*, Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1153 n.17 (Del. 1989).
[138] *Unocal*, at 955.
[139] 506 A.2d 173, 182 (Del. 1986).
[140] See Gilson and Kraakman, *supra* note 136, at 267& n.65.

(i) *AC Acquisitions Corp. v. Anderson, Clayton & Co.*[141] – the target company's defensive response (a series of transactions including a self-tender offer, a recapitalisation, and sale of stock to an Employee Plan) was held to be unreasonable in relation to the threat posed, for being coercive, even though the court found the tender offer posed a valid threat to the company's reorganisation plans.

(ii) *Robert M. Bass Group, Inc. v. Evans*[142] – it was found that there had been no cognisable threat to the target company because the tender offer was not coercive, and even if the board felt that the price was inadequate, it was simply an opening bid made by the tender offeror which could be negotiated upwards. The court then held the defensive measure (a corporate restructuring) to be unreasonable for being coercive and economically inferior to the supposed threat of the takeover offer.

(iii) *City Capital Associates Ltd. Partnership v. Interco, Inc.*[143] – the court recognised the threat that shareholders might not accept their directors' superior intrinsic valuation of the company thereby tendering into the offer to their detriment. Nonetheless, the court found that refusing to redeem the pill was not a reasonable response to the "mild" threat, because it precluded shareholder choice i.e. it was coercive.

(iv) *Grand Metropolitan Public Ltd Co. v. Pillsbury Co.*[144] – the court found that the only threat posed by the tender offer was inadequate value, and not a threat to the corporation itself or any other constituency. It was held that the refusal

[141] 519 A.2d 103 (Del. Ch. 1986).
[142] 552 A.2d 1227 (Del. Ch. 1988).
[143] 551 A.2d 787 (Del. Ch. 1988).
[144] 558 A.2d 1049 (Del. Ch. 1988).

of the board to redeem the pill combined with its restructuring plans was an unreasonable response to the threat of inadequate value, for being coercive.

A common thread running through the above cases is that the court found the defensive measures unreasonable for being coercive, even though in most cases the court acknowledged that there had been valid (and at the very least, mild) threats. In all of these cases, the directors had implemented corporate restructuring plans which were at varying stages of development. Chiefly for the foregoing reason, the court found the defensive measures to be unreasonable because they prevented shareholders from choosing between the company's restructuring plans and the tender offer; the directors were practically compelling their restructuring plans on the shareholders.

It was in this era when shareholder interests were held sacrosanct, that Gilson & Kraakman wrote their article depicting the "typology of threats," all of which described threats to shareholders. None of the cases summarised above was appealed before the Delaware Supreme Court, and so the doctrine of shareholder primacy in takeovers developed by the Chancery had not been subjected to review. But it was only a question of time.

Before the ink on the Gilson & Kraakman article could have properly dried and while Martin Lipton and fellow advocates of a board's right to defend against a takeover were still trying to absorb the consequences of the *Interco* decision, the Delaware Supreme Court got its chance to contribute to the discourse in *Paramount Communications, Inc. v. Time, Inc.*[145] The facts follow.

Time, Inc. ("Time") and Warner Communication, Inc. ("Warner") had been pursuing a long term plan for a merger between the two companies, ever before Paramount Communications, Inc. ("Paramount") entered the picture with a conditional fully negotiable all-cash all-shares tender offer at $175 per share which was later increased to $200 per share

[145] 571 A.2d 1140 (Del. 1989).

(the "Paramount offer"). Time decided that the Paramount offer was inadequate, and restructured its merger with Warner as a tender offer for 51% of the shares of Warner (the "Time offer"). Paramount and certain Time shareholders who wished to tender into the Paramount offer (the "shareholder plaintiffs") brought action to enjoin the Time offer, and to compel the Time board to fulfil its Revlon duties[146] to its shareholders with respect to the Paramount offer. The Time board contended that the Paramount offer was a threat to the planned merger with Warner, which necessitated a defensive response in the form of the Time offer.

The court framed the ultimate question integral to this case as follows: "[d]id Time's board, having developed a strategic plan of global expansion to be launched through a business combination with Warner, come under a fiduciary duty to jettison its plan and put the corporation's future in the hands of its shareholders?"[147] The court found the Time offer to be reasonable in relation to the threat which the Paramount offer posed to the Time Warner merger emphasising that, "a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover."[148]

We need look no further than this for proof that the Delaware Supreme Court did not understand its jurisprudence on cognisable threats as set out in *Unocal* to be governed by shareholder primacy. Therefore the Delaware Supreme Court in this case, recognised Paramount's offer as a threat to Time's "strategic objectives," which included a "preservation of Time's culture."[149]

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[146] This is a duty to maximize immediate share value.
[147] *Time, Inc.*, *supra* note 145, at 1149.
[148] *Id.* at 1150.
[149] *Id*. at 1152.

In a previous case,[150] the Delaware Supreme Court had acknowledged that a takeover defence which enabled the directors to maintain the company's independence through facilitating a third party's purchase of the company's shares, was reasonable in relation to the threat posed by the tender offer to the company's "continued independence".[151]

In *Versata Enterprises, Inc. v. Selectica, Inc.*,[152] yet another threat was recognised under Delaware law. The defendant company had Net Operating Losses (NOLs) which were a valuable asset because they could be carried forward and set off against future tax liability. Pursuant to a provision of the Internal Revenue Code,[153] "where (A) there is any change in the respective ownership of stock of a corporation, and (B) such change affects the percentage of stock of such corporation owned by any person who is a 5-percent shareholder before or after such change," a company may lose some benefit of the NOLs. With this in mind, the defendant directors lowered the trigger for the existing Rights Plan to 4.99% in order to protect the NOLs. The plaintiff deliberately triggered the pill thereby endangering the NOLs. Delaware Supreme Court recognised that the NOLs were a valuable asset to the company and the attempt by the plaintiff to buy through the pill was a serious threat to the company's assets, which justified a lower threshold poison pill.

In *Moore Corp. Ltd. v. Wallace Computer Services, Inc.*, the District Court of Delaware, applying Delaware law acknowledged that the threat posed was different than most other threats.[154] In this instance, rather than a threat to the company's future plans,[155] the tender offer posed a threat to the benefits of the board's past investments and operations which were only beginning to manifest, and the financial data which demonstrated these results were facts only known to the board. Therefore, the tender offer posed a threat that

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[150] Ivanhoe Partners v. Newmont Min. Corp., 535 A.2d 1334, 1344 (Del. 1987).
[151] *Id.* at 1339.
[152] 5 A.3d 586 (Del. 2010).
[153] 26 U.S.C. § 382.
[154] 907 F. Supp. 1545, 1560 (D. Del. 1995).
[155] In *Time, Inc.*, the threat was to Time's deliberately conceived plan to enter into a merger with Warner which had not been concluded, thereby making it a threat to a future plan.

shareholders might tender their shares in ignorance of the potential of their company. This threat has been called the "uninformed shareholder threat."[156]

B. Proportionality

1. Proportionality and Tender Offer Defences

Although the *Unocal* decision could have been clearer in setting a standard for assessing when a defensive measure is reasonably related to the perceived threat, the Delaware Supreme Court nevertheless provided direction when it stated that while directors have a duty to protect the corporation against takeovers, they do not have the liberty to defend against any perceived threat using "draconian" means.[157] Presumably therefore, a reasonably related defensive measure is one which is not draconian. Subsequent cases immediately following *Unocal* did not provide any more guidance on how the court would analyse the reasonableness of a defensive measure. For instance, in *Moran v. Household Intern., Inc.*,[158] a case in which the Rights Plan[159] as a defensive measure was on trial for the very first time, the Unocal standard did not apply because the defensive measure was not in response to any particular takeover threat – rather it had been put in place before any tender offer in order to ward off possible takeover attempts. Nevertheless, the court concluded that the Rights Plan was a reasonable defensive mechanism to protect the company from the bidder's coercive acquisition techniques; no reason was given for this conclusion.[160]

[156] *See generally*, Neil C. Rifkind, *Should Uninformed Shareholders Be A Threat Justifying Defensive Action By Target Directors in Delaware?: "Just Say No" After Moore v. Wallace*, 78 B. U. L. REV. 105, 128 (1998).
[157] See Moore Corp. Ltd. v. Wallace Computer Services, Inc., 907 F.Supp 1545, 1562 (D. Del. 1995) (where the court said, "[w]hile *Unocal* gave no direct guidance to courts applying the proportionality test, the Court did expressly define the outer parameter of board action by condemning any action which is "draconian" as *not* reasonably proportionate to the perceived threat.")
[158] 500 A.2d 1346 (Del. 1985).
[159] Also known as the "poison pill," a Rights Plan is an option provided to the shareholders of a company upon certain triggers (usually, a tender offer), to acquire additional shares of the company at a greatly reduced rate, usually half price. This offer does not extend to the tender offeror and the effect of the Rights Plan is to dilute the shareholding of the tender offeror and to make it a lot more expensive to acquire sufficient shares of the company to gain control.
[160] In a sense, the Rights Plan can hardly be considered preclusive or coercive. The shareholders still have the right to sell their shares on the market, they can refuse to exercise the Rights, and possibly the tender offeror can

Revlon[161] did not shed any more light on the elements of a proportional response, even though in that case, the Rights Plan was also found to be a reasonable response to an inadequate bid.

The elements of what would constitute a reasonable response to a takeover threat began to form in the 1986 decision *of AC Acquisitions Corp. v. Anderson, Clayton & Co.*, where Chancellor Allen opined that a defensive self-tender offer is an unreasonable response to tender offer. The court in that case held the board's self-tender offer defensive response to be unreasonable for being coercive and preclusive in light of the "minimal" threat. [162]

Chancellor Allen attempted, three years after *Unocal*, to establish a definite correlation between a tender offer whose only threat is inadequate consideration and what would constitute an unreasonable response in relation to that threat. According to him, "[w]here an offer is not coercive or deceptive (and, therefore, what is in issue is essentially whether the consideration it offers is attractive or not), a board … is not authorised to take preclusive action."[163] The Chancellor was effectively stating that where the sole threat is of the inadequate price offered by the takeover sponsor, any preclusive defensive measure, which in this case was the refusal to dismantle a Rights Plan, would be an unreasonable response.[164]

Fast forward to 1989 where the Delaware Supreme Court would confirm in *Paramount Communications, Inc. v. Time, Inc.*, that a defensive measure which is not

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condition its initial offer on the possibility of prorating and reducing its offer price if the shareholders exercise the Rights.

[161] 506 A.2d 173 (Del. 1986).

[162] 519 A.2d 103, 114 (Del. Ch. 1986) ("a defensive step that includes a *coercive* self-tender timed to effectively *preclude* a rational shareholder from accepting the any-and-all [cash] offer, cannot, in my opinion, be deemed to be reasonable in relation to any minimal threat posed to stockholders by such offer." (emphasis added)). In that sense, preclusive action was one which stripped shareholders of their right to choose.

[163] City Capital Associates Ltd. Partnership v. Interco Inc., 551 A.2d 787, 797 (Del. Ch. 1988), *overruled by* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1152-3 (1989).

[164] Chancellor Allen would go on to admit that this thinking was not the position of the law ("Our law however has not adopted that view and experience has demonstrated the wisdom of that choice. We have held that a board is not required simply by reason of the existence of a noncoercive offer to redeem outstanding poison pill rights.") (citation omitted), *Interco*, *supra* note 163, at 797.

coercive or preclusive, is a proportional response.[165] More importantly in this case however, the Delaware Supreme Court rejected the Chancery Court's precedents that an all-cash, all-shares offer does not constitute a cognisable threat, unless the value of the offer is clearly inadequate. In the opinion of the court, delving into valuation issues would raise all sorts of questions which the courts are not properly placed to deal with; such matters should be left firmly within the business judgment of the directors.[166] Restated, an all-cash, all-shares offer with a reasonable value is a valid threat against which the directors of a company could adopt a defensive measure.

In *Paramount Communications, Inc. v. QVC Network, Inc.*, it was held that a reasonable response need not be perfect, as long as it falls within a "range of reasonableness."[167]

It was not until 10 years after *Unocal*, in *Unitrin, Inc. v. American General Corp.*, that the Delaware Supreme Court eventually provided a comprehensive review of the elements of proportionality.[168] As it stands presently, a defensive measure will be found to be reasonable in relation to a threat[169] if it is: (i) not preclusive, (ii) not coercive, and (iii) falls within a range of reasonableness. A measure is not coercive if it does not force a particular option on the shareholders; it is not preclusive if it does not bar effectively any possibility of the takeover of the company; and it falls within a range of reasonableness if it is within the

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[165] 571 A.2d 1140, 1154-1155 (1989).
[166] *Id*., at 1152-53.
[167] 637 A.2d 34, 45 (Del. 1993). In addition to the requirement that a reasonable response need not be perfect, the Delaware Supreme Court also made it clear that necessity is not a requirement of a reasonable response. The court stated specifically that the Chancery's determination that a defensive measure was unnecessary "constituted a substitution of its business judgment for that of the board , contrary to this Court's "range of reasonableness" holding in Paramount Communications, Inc. v QVC Network, Inc. (citation omitted)," *Unitrin*, 651 A.2d 1361, 1386 (Del. 1995).
[168] 651 A.2d 1361 (Del. 1995).
[169] And going by the decision in *Time, Inc.*, *supra* note 165, a threat includes a reasonably valued all-cash all-shares offer.

powers of the board, corresponds in degree and magnitude with the perceived threat, and accommodates varied shareholder preferences.[170]

It bears noting that the reasonableness of a defensive measure was intended to be directly related to the nature of the threat involved, but with the decision in *Unitrin*, this may no longer be the case. It used to be that proportionality required a balancing of the response against the threat. The board needed to have balanced the threat presented by the tender offer, against the defensive response. With *Unitrin*, it appears that what is required is for the defensive measure to fall within a "range of reasonableness," whether or not it directly corresponds with the threat.[171]

2. Proportionality and Deal Protection Devices

Thus far, this paper has discussed the 2-step analysis of defensive measures devised under *Unocal* solely with regard to tender offers, in which directors might be conflicted because of the possible change of control of the company if the tender offer succeeds. That however does not end the enquiry under Unocal. There is a separate set of circumstances under which the Unocal test is applicable, known as "deal protection devices."

Deal protection devices are defensive measures employed differently than in tender offers. Where the board of one company has completed mutual merger negotiations with another company and in order to forestall a situation where a third party could scuttle that agreement, the parties to the negotiated merger agreement would often include deal protection devices in the merger agreement or in a separate agreement, prior to such a time as the merger is consummated upon receiving the necessary approvals.[172] The purpose of the

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[170] *Unitrin*, *supra* note 167, at 1387,1389.
[171] *But see*, Versata Enterprises, Inc. v. Selectica, Inc., 5 A.3d 586, 606-607 (Del. 2010) (where it appeared the Supreme Court hearkened back to the foundation of Unocal when it found that the Selectica board's low-threshold poison pill was proportional to the threat to its impaired NOLs).
[172] For a discussion on deal protection devices, *see*, Thanos Panagopoulos, *Thinking Inside The Box: Analysing Judicial Scrutiny of Deal Protection Devices in Delaware*, 3 BERKELEY BUS. L.J. 437 (2005-2006); Eleonora Gerasimchuk, *Stretching the Limits of Deal Protection Devices: From Omnicare to Wachovia*, 15 FORDHAM J. CORP. & FIN. L. 685 (2009-2010).

deal protection devices is to deter, or in extreme cases, foreclose any possibility of a third party proposing an alternative merger arrangement, or in some instances deterring activist shareholders from challenging the agreement, even in the absence of an alternative merger proposal.

The purpose of this paper is not to go into a thorough analysis of deal protection devices and the legal issues surrounding it. However, the analysis of the Unocal test will not be complete without acknowledging the interplay between Unocal and deal protection devices. There are lessons to be drawn and comparisons to be made between the body of case law dealing with deal protection devices and tender offer defensive measures.

There are key differences between the circumstances where deal protection devices and tender offer defensive measures are employed: (i) the merger, pursuant to which deal protection devices are used, is a mutually negotiated transactions, unlike the unilateral tender offer that gives rise to defensive measures; (ii) deal protection devices are the result of a legal contract between the parties to the merger, while defensive measures are often unilaterally decided by the directors; and (iii) the hallmark of a successful tender offer is a change in control of the target company, which is not necessarily the case in merger agreements where the old management is often retained.

In *Time, Inc.*, discussed above,[173] the court held that "the adoption of structural safety devices, . . . are properly subject to a Unocal analysis."[174] It is not immediately obvious why the Unocal analysis applies to deal protection devices, after all Unocal was developed as a result of the "omnipresent spectre" that directors would be acting in their self-interest because of the change of control which is inherent in takeover offers. What then is the conflict of interest applicable in merger agreements with deal protection devices, since change of control does not often arise in negotiated merger agreements? According to the court in *Omnicare,*

[173] See discussion at page 38.
[174] *Time, Inc.*, 571 A.2d at 1151.

Inc. v. NCS Healthcare, Inc., "[i]t is well established that conflicts of interest arise when a board of directors acts to prevent stockholders from effectively exercising their right to vote contrary to the will of the board. The "omnipresent spectre" of such conflict may be present whenever a board adopts defensive devices to protect a merger agreement."[175] There is an inherent tension where directors employ deal protection devices in merger agreements. Delaware corporation law – and this is typical in other States – provides that a merger requires the approval of the shareholders of the affected companies before it becomes effective.[176] If the directors have proceeded to insert deal protection devices which for all practical purposes lock up the merger, then the shareholders essentially have no say in the matter.

Applying the Unocal analysis to deal protection devices similarly requires an examination of the threat and the reasonableness of the response. As the court in *Omnicare* put it,

> A board's decision to protect its decision to enter a merger agreement with defensive devices against uninvited competing transactions that may emerge is analogous to a board's decision to protect against dangers to corporate policy and effectiveness when it adopts defensive measures in a hostile takeover contest.[177]

The insular "threat" with respect to which deal protection devices are employed is to "protect a merger agreement that will not result in a change of control."[178] The defensive devices may be used as much to protect against a threat, as to secure the potential benefits of

[175] 818 A.2d 914, 930.
[176] See DEL CODE ANN. TIT. 8, § 251 (c) (2010).
[177] *Supra* note 175, at 932.
[178] *Supra* note 175, at 932. This is the antithesis of the typical Unocal standard, which applies in change of control situations. However, sometimes, as we saw in Paramount, Inc. v. QVC, Inc. 637 A.2d 34, 49, deal protection devices have been employed even where the proposed transaction results in a change of control ("The directors also decided at that time that it was appropriate to agree to certain defensive measures (the Stock Option Agreement, the Termination Fee, and the No–Shop Provision) insisted upon by Viacom as part of that economic transaction. Those defensive measures, coupled with the sale of control and subsequent disparate treatment of competing bidders, implicated the judicial scrutiny of *Unocal* . . . and [its] progeny.")

a particular transaction vis-à-vis a competing one.[179] Accordingly, rather than a determination that there was a threat to corporate policy and effectiveness, there would be a determination that the uninvited merger offer poses a threat to the existing transaction, or that the preferred transaction enhances shareholder interests. In the same vein, the deal protection devices must be proportional.[180] As in *Unocal*, the process and the decision must be reasonable.

In *Paramount, Inc. v. QVC, Inc.,* the court held that the defensive devices were unreasonable because they "were improperly designed to deter potential bidders."[181] This translates into the defensive devises being preclusive. The defensive devices in this particular case included a "No-Shop Provision" that prevented the directors of Paramount from seeking out or negotiating offers from third parties; a Stock Option Agreement which included draconian provisions; and a prohibitive Termination Fee.

In *Omnicare, Inc. v. NCS Healthcare, Inc.*,[182] the Delaware Supreme court held the defensive devices therein to be unreasonable in relation to the threat of losing the previously negotiated offer and being left without an alternative, for being preclusive (they barred the board from considering a superior merger transaction) and coercive (because they were designed to impose the merger transaction which the board had selected). The defensive devices in this case were:

a. "Force the Vote" provision – which compelled the directors of the company to put the merger agreement to a vote in a shareholders meeting, even where the directors have withdrawn their recommendation of the merger;

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[179] See Paramount, Inc. v. QVC, Inc., 637 A.2d at 45. It should be noted that this case was decided using the Revlon test, and not Unocal, because although the transaction at issue was a stock-for-stock merger, it would lead to the combined companies having a controlling shareholder therefore leading to a change of control. By reason of the fact that the shareholders of the company would therefore lose any chance in the future to realize a control premium, it was imperative for the directors' duty to change to that of obtaining the highest value possible for the shareholders.
[180] *Id*. at 45, ("[T]he board's action must be reasonable in relation to the advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests.")
[181] *Id*. at 50.
[182] 818 A.2d 914 (Del. 2003).

b. Conditional "No-Shop" provision – which prevented the board of the company from negotiating with third parties for the purpose of reaching an alternative merger deal;

c. Voting Agreement – by which two directors, in their capacity as shareholders with majority voting power, pledged to vote their shares in favour of the merger; and

d. Termination Fee – this was high enough that it would discourage most bidders, who would have to bear the cost.

These deal protection devices were found to be preclusive and coercive in the absence of an effective fiduciary out clause,[183] and therefore outside of a range of reasonableness. This therefore made it "realistically unattainable" and "mathematically impossible" for any other merger proposal to succeed.[184]

The *Omnicare* decision was received none too positively. It has been subjected to the most damning criticisms, with one critic stating that the principle upon which the case was decided was "unfounded" and calling for its reversal,[185] and a particularly scathing criticism declaring that rule in the case is "bad law, bad economics, and bad policy."[186] The dissent in that case even went as far as to say that it hoped that the rule announced in the case would be "interpreted narrowly and will be seen as sui generis."[187] The object of much of the critique is the inflexible bright line rule that was adopted: "a merger agreement entered into after a market search, before any prospect of a topping bid has emerged, which locks up stockholder

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[183] A fiduciary out clause is an escape clause in the merger agreement that allows the merger agreement to be avoided, where approving the merger would conflict with the directors' fiduciary duties.
[184] *Omnicare*, *supra* note 182, at 936.
[185] See Panagopoulos, *supra* note 172, at 466.
[186] See Sean J. Griffith, *The Costs and Benefits of Precommitment: An Appraisal of Omnicare v. NCS Healthcare*, 29 IOWA J. CORP. L. 569, 623 (2004).
[187] Chief Justice Veasey in *Omnicare*, *supra* note 182, at 946.

approval and does not contain a "fiduciary out" provision, is per se invalid when a later significant topping bid emerges."[188]

A brief recap of the facts is important to understanding the controversy surrounding the decision.

Omnicare Facts[189]

Beginning in late 1999, NCS Healthcare, Inc., hit challenging times as a result of which it had to consider strategic alternatives to weather the storm. As part of the proposals, it entered into negotiations with Omnicare about a possible deal. Omnicare's offered to structure the deal as an asset sale in bankruptcy in which only NCS's creditors would get any recovery, and even then only a partial recovery; the shareholders would get nothing. Later on, NCS's financial position began to strengthen and it felt it could do better than the Omnicare offer.

A different company, Genesis proposed a transaction outside the bankruptcy context. Subsequently, the NCS directors agreed to the terms of a merger with Genesis. Pursuant to that agreement, all of the NCS creditors would be paid in full and the corporation's stockholders would exchange their shares for the shares of Genesis. This offer was however on the condition that NCS would not engage in any alternative or superior transaction in the future; apparently Genesis was suspicious of Omnicare and wished to prevent a repeat of earlier encounters in which it had lost out to Omnicare on other acquisition transactions. To this end, deal protection devices were included in the merger agreement and in a separate voting agreement to secure this concession. The voting agreement required that 2 of NCS's directors who in their capacity as stockholders had majority voting power (over 50%) but not majority shareholding, would vote in favour of the Genesis merger; also, the directors were

[188] *Id*. at 942.
[189] Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).

required to bring the merger before a shareholders' meeting for a vote whether or not they still intended to recommend the Genesis merger.

Genesis's suspicions turned out to be correct. As soon as Omnicare got whiff of the negotiations between NCS and Genesis, it suddenly revived its interest in NCS and retraced its steps from its earlier proposal of a deal in the bankruptcy context. This time around it offered terms that were superior to the Genesis deal. The competing Omnicare bid offered the NCS stockholders an amount of cash equal to more than twice the then current market value of the shares to be received in the Genesis merger. The transaction offered by Omnicare also treated the NCS corporation's other stakeholders (e.g. the noteholders) on equal terms with the Genesis agreement. Several months after approving the Genesis merger agreement, but before the stockholder vote was scheduled, the NCS board of directors withdrew its prior recommendation in favour of the Genesis merger. In fact, the NCS board recommended that the stockholders reject the Genesis transaction after deciding that the competing proposal from Omnicare was a superior transaction. The withdrawal of the recommendation however would have no effect because of the deal protection devices contained in the Genesis agreement. Omnicare therefore brought action to enjoin the Genesis merger on fiduciary duty grounds.

Comments on *Omnicare*

I do not intend to contribute to the criticism of the *Omnicar*e decision; there is already enough of that to go around. My angle on the case is to attempt to understand the Delaware Supreme Court's volte face in this ruling.[190] First, this is a court that has shied away from bright line rulings in the past with regard to defensive measures; even Chancellor Allen's attempt at drawing a bright line rule in *Interco* that keeping a poison pill after a board has presented an alternative restructuring transaction to the shareholders is a disproportionate

[190] *See also*, Wayne O. Hanewicz, *Director Primacy and Omnicare*, http://www.law.ufl.edu/faculty/pdf/9-4-03hanew.pdf (last visited Jan. 15, 2012) (in which the author attempted to "make sense" of the Omnicare decision).

response where the only threat is the "mild" one of inadequate value, was disapproved of by the Delaware Supreme Court. Second, this is a court that had never ruled against a tender offer defensive measure that was before it on appeal applying Unocal, and had in fact overruled the Chancery's attempts to do so.[191] In addition, the NCS board was actually following the principle in *Revlon* that there should be rationally related benefits to shareholders whenever directors are considering other constituencies. If it were left to Omnicare in its initial offer, the shareholders would not have realised any benefits from the merger; but the directors were able to negotiate benefits for different constituencies (the noteholders and the shareholders) in the Genesis agreement.

It had seemed that in hostile takeovers, the Delaware Supreme Court had been tilting towards director primacy; what could have caused this change to a shareholder primacy model? This may have something to do with the two basic rights of shareholders in a corporation i.e. the right to vote and the right to sell their shares.[192]

(i) Voting Right – It has been said that the validity of directorial power depends on the opportunity for shareholders to exercise control over the directors, and the most important expression of their control right is the right to vote, in whatever form.[193] The manifestation of the importance of voting power is expressed most simply by the fact that even though directors manage the company and have the final say on most issues affecting the company; it is shareholders who elect directors. Corporation laws also list other corporate matters over which shareholders may exercise their franchise. One of such

[191] See *supra* note 116.
[192] According to Thompson and Smith, *supra* note 21, at 276, the rights of shareholders are the right to "vote, sell, or sue". *See also*, Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651, 659 ("[g]enerally, shareholders have only two protections against perceived inadequate performance. They may sell their stock . . . or they may vote to replace incumbent board members.")
[193] Thompson and Smith, *supra* note 21, at 299. The reason for this could be that even though directors manage the company, the right of the shareholders to appoint and remove directors serves as a check on the powers of the directors.

matters is the approval of mergers negotiated by the directors. Delaware General Corporation Law for instance provides that:

> The [merger] agreement . . . shall be submitted to the stockholders of each constituent corporation at an annual or special meeting for the purpose of acting on the agreement . . . . At the meeting, the agreement shall be considered and a vote taken for its adoption or rejection.[194]

(ii) Selling Right – This is the other fundamental right of shareholders (and to some commentators, a more important protection of the shareholder interest than the voting power).[195] Unlike voting rights which are clearly specified throughout the corporate statute, the right to sell while not clearly stated is clearly implied. This is apparent where for instance Delaware General Corporation Law provides for restrictions on the transfer of shares.[196] There would have been no need to restrict transfer of shares if there were no right to transfer same in the first place. However, even though there is a right to transfer shares, there is nothing in the law that guarantees the right to sell shares as a block, as would be the case in tender offers. Thus, while shareholders would always have the right to sell their shares individually on the market or through private contracts, the right to sell as a group possibly does not rise to the level that requires enhanced protection.[197]

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[194] See *supra* note 176.
[195] Leo E. Strine, *Categorical Confusion: Deal Protection Measures In Stock-For-Stock Merger Agreements*, 56 BUS. LAW. 919, 925 (2001), ("As a practical matter, the ability of investors to sell may be their most important protection. Although the right to vote shares is significant, investors for the most part own stock to make money."); see also Leo Strine, *supra* n.18 (stating that many sophisticated commentators view Delaware case law treating stockholder voting rights as more important than the right to receive tender offers, as misguided). I hold a different view from these commentators, and side with the view that voting rights are the most important rights held by shareholders. Ownership rights imply both the right to control and the right to dispose. The right of control applies throughout the ownership period, and is lost upon sale of the property; control rights therefore always precede sale right. *But see*, Robert P. Thompson, *Preemption and Federalism In Corporate Governance: Protecting Shareholder Rights To Vote, Sell, and Sue*, 62 LAW AND CONTEMP. PROBLEMS 215 (1999) (stating that there is now increased emphasis on the shareholders' voting rights compared to other shareholder rights, such as selling or suing).
[196] See DEL CODE ANN. TIT. 8, § 202(1) (2010).
[197] *But see*, Thompson and Smith, *supra* note 21, at 304 n.209.

It may well be that the Delaware Supreme Court has grappled with the shareholder interests that require protection through enhanced scrutiny and has, at least subconsciously, devised a hierarchy of interests and the amount of deference to be given to those interests by the courts. As the Chancery noted in *Blasius*, "when viewed from a broad institutional perspective, . . . matters involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power;"[198] and the Delaware Supreme Court "agree[s] with the broad principles in Blasius."[199] In fact, the Delaware Supreme Court went to state that the rules in *Blasius* and *Unocal* "are not mutually exclusive because both recognize the inherent conflicts of interest that arise when shareholders are not permitted free exercise of their franchise," and citing *Shamrock Holdings, Inc. v. Polaroid Corp.*,[200] stated that *Blasius* is a "specific expression" of the proportionality element of Unocal.[201] Specifically, the Delaware Supreme Court in *Stroud* said, "[i]n certain circumstances, a court must recognize the special import of protecting the shareholders' franchise within *Unocal* 's requirement that any defensive measure be proportionate and "reasonable in relation to the threat posed.""

Although the cases discussed in the preceding paragraph deal with shareholders' franchise as it relates to appointment of directors, the analogy can be extended to shareholder franchise in any matter for which shareholders have a voting right, including the right to approve a merger transaction. In fact, the *Omnicare* decision was based on the holding that the shareholder vote was coerced. As the court said, "[a] stockholder vote may be nullified by wrongful coercion "where the board or some other party takes actions which have the effect of causing the stockholders to vote in favour of the proposed transaction for some reason

[198] 564 A.2d 651, 659.
[199] Stroud v. Grace, 606 A.2d 75, 79 (Del. 1992).
[200] 559 A.2d 278, 285-85 (Del. Ch. 1989).
[201] Stroud v. Grace, 606 A.2d 75, 92 n.3.

other than the merits of that transaction.""[202] The vote in this case was coerced because even though the majority stockholders of NCS supported the Omnicare offer, it made no difference because the deal protection devices ensured that the Genesis offer would be the winning offer.[203] Therefore, without directly applying *Blasius* or the "compelling justification" test embedded in it, the *Omnicare* court gave primacy to shareholder franchise.[204] Delaware Supreme Court may have felt bound to decide *Omnicare* according to the provision of the law that it is the shareholders' prerogative to approve mergers; in such a case, the Court would interpret strictly against all agreements or devices that infringe on this right.

On the other hand, there is no rule that provides for the rights of shareholders to tender their shares as a group. As the Chancery said, "shareholders do not possess a contractual right to receive takeover bids. The shareholders' ability to gain premiums through takeover activity is subject to the good faith business judgment of the board of directors in structuring defensive tactics."[205] Thus, where directors adopt defensive measures that interfere with the shareholders' choice to tender as a group, there is no statutory (or contractual) authority to compel or motivate courts to take a stand against such defensive measures.[206] As a result, the courts construe tender offer defensive measures under the sweeping powers given to directors of a corporation to manage the business and affairs of a

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[202] *Omnicare*, 818 A.2d 914, 935 (citing its decision in Williams v. Geier, 671 A.2d 1368 (Del. 1996)).

[203] Although the stockholders with majority holdings supported the Omnicare offer, their voting power was substantially weaker than the minority shareholders because of the differences in classes of shares.

[204] It would have been self-defeating of the *Omnicare* court to apply Blasius. As the court in State of Wisconsin Inv. Bd. v. Peerless Systems Corp., 27 Del. J. Corp. 726 (Del. Ch. 2000) noted, "Blasius does not apply in all cases where a board of directors has interfered with a shareholder vote." *See also*, Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996) (stating that the compelling justification standard of Blasius applies only where the primary purpose of the Board is to interfere with the shareholder vote). It is apparent in the Omnicare case, that the board's primary purpose in agreeing to the deal protection devices was to secure the Genesis transaction, and not to impede the shareholder vote.

[205] Moran v. Household Intern, Inc., 490 A.2d 1059, 1070 (Del. Ch. 1985) *aff'd* on other grounds. Of course, now we know that since *Unocal*, the board's decision to employ defensive tactics is reviewed under an enhanced standard, rather than the business judgment rule that was applicable at the time the Chancery decided this case.

[206] See Thompson, *supra* note 195, 237-38 (1999) (stating that Delaware case law allows directors more discretion in applying defensive measures to tender offers than in defensive tactics that block shareholder voting decisions. The writer attributes this to the state of the law which has a limited role in regulating shareholder decisions to sell).

company.[207] The reverse is the case with mergers. Although the directors have broad powers to direct and manage the affairs of a company, these powers are limited under other provisions including the provisions that give shareholders the power to approve mergers.[208]

To summarise, the range of reasonable responses under the proportionality review of Unocal does not allow for measures that compromise the shareholder franchise. If viewed in the light of the reasoning above, perhaps the *Omnicare* decision might not be so controversial.

The analysis would be incomplete without stacking my deduction about *Omnicare* against the conclusion in Part V.B above that the Delaware Supreme Court's intended all along to apply Unocal's proportionality prong in a somewhat deferential manner, similar to the rational basis test applied by the U.S. Supreme Court. The *Omnicare* decision can in no way be considered a deferential application of proportionality review. So, what gives? Although the U.S. Supreme Court's application of the rational basis test is noted to be deferential, there have been a number of cases that failed its rationality review. In these cases, it is said that the Court is applying a more exacting rational basis test, one with "bite."[209] According to Chemerinsky, "[t]he claim is that there is not a singular rational basis test, but one that varies between complete deference and substantial rigor."[210] It is perhaps in the light of the more rigorous proportionality standard that the Delaware Supreme Court found the deal protection devices in *Omnicare* unreasonable.

[207] See DEL CODE ANN. TIT. 8, § 141(a) (2010).
[208] *See, e.g.*, MODEL Bus. CORP. ACT § 11.03 (1990).
[209] CHEMERINSKY, *supra* note 82, at 696.
[210] *See further*, Russell W. Galloway, *Means-End Scrutiny in American Constitutional Law*, 21 LOY. L.A. L. REV. 449, 452 (1988).

The discussion in this Paper has focused entirely on Delaware corporation law. One might wonder why this is the case, when there are 50 states in the United States, all of which have corporations domiciled within them. Delaware's relevance can be traced to the early 1900s when it became the incorporation destination of choice. Today, more than half of the Fortune 500 companies are incorporated in Delaware and this is a good representation of companies outside the Fortune 500 as well.[211] Anecdotally, Delaware's "charm rests largely in its business-friendly corporate laws. It lets people file anonymously and offers some protection from shareholders . . . . "[212] Among the reasons for Delaware's pre-eminence include: the Delaware General Corporation Law, the development of case law, and the sophisticated Chancery Court.[213]

Nonetheless, there is life outside Delaware, and an incursion into the takeover laws outside Delaware is significant to our understanding of takeover jurisprudence in general. The most obvious difference between Delaware and other states is that most other states have elevated to the status of legislation, principles that remain common law in Delaware, in other words, "defensive tactics statutes."[214] One type of these statutes authorise the use of the flip-in feature of the poison pill as a defensive mechanism,[215] while another type allows directors to consider other constituencies as well as the long-term prospects of the company in crafting responses to tender offers.[216] These powers are likewise available under Delaware, but as decided by case law and not statute e.g. *Moran* authorised the use of the poison pill while

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[211] Michael Barzuza, *The State of State Anti-Takeover Law*, 95 VIR. L. REV. 1973, 2039 (2009).

[212] Carol Vinzant, *Why Do Corporations Love Delaware So Much?*, CNN MONEY (Feb. 01, 1999), http://money.cnn.com/magazines/fortune/fortune_archive/1999/02/01/254400/index.htm.

[213] Lewis S. Black, Jnr., *Why Corporations Choose Delaware*, *available at* http://corp.delaware.gov/whycorporations_web.pdf (last visited Jan. 17, 2012).

[214] See Barzuza, *supra* note 211, at 1987. The "flip-in" is the feature of the poison pill that allows shareholders except the tender offeror to buy additional shares of the company at a generous discount.

[215] *See e.g.*, Mass. Gen. Laws Ann. ch. 156B, § 65 (West).

[216] See Barzuza, *supra* note 211, at 1987- 89.

Unocal and *Revlon* permitted directors to consider constituencies other than shareholders in responding to tender offers. Of course, unlike the principle in Delaware developed in *Moran* that directors do not have "unfettered discretion in refusing to redeem the Right",[217] and which threatens that directors' use of the pill "will be evaluated when and if the issue arises,"[218] states with statutorily approved poison pills do not have such provisions. An example of an enactment authorising the statutory flip-in feature of the pill is as follows:

> (a) A corporation may issue rights, options or warrants for the purchase of shares or other securities of the corporation. The board of directors shall determine (1) the terms upon which the rights, options or warrants are issued, and (2) the terms upon which, including the consideration for which, the shares or other securities are to be issued….
> (b) The terms and conditions of such rights, options or warrants, …, may include, …, restrictions or conditions that: (1) *Preclude* or limit the exercise, transfer or *receipt of such rights*, options or warrants *by any person or persons owning* or offering to acquire *a specified number or percentage of the outstanding shares* or other securities of the corporation or by any transferee or transferees of any such person or persons; or (2) invalidate or void such rights, options or warrants held by any such person or persons or any such transferee or transferees.[219]

Still, Chancery's attempt to mandate the directors in *Interco* to redeem the pill was disapproved of by the Delaware Supreme Court in *Time, Inc.* To this extent, Delaware provisions on the poison pill may not be so different from that which is applicable in other states which allows directors to maintain poison pills indefinitely.

What differentiates Delaware from most of the other States however, is the applicable judicial standard of review in change of control situations. The foundational principle in Delaware is that because of the "omnipresent spectre" that directors may be acting in their own interest in change of control situations, the courts would apply an enhanced level of judicial scrutiny which deprives directors of the presumption of the business judgment rule

[217] *Moran*, 500 A.2d at 1354.
[218] *Id.* at 1357.
[219] Conn. Gen. Stat. Ann. § 33-675 (West) (emphasis added).

until they discharge the 2 prong Unocal test.[220] The increased burden, which Delaware imposes on its directors as a result of the enhanced judicial review of takeover defences, is simply not applicable in many other states. This is due to yet another feature of the defensive tactics statutes, an example of which provides as follows:

> Absent breach of fiduciary duty, lack of good faith or self-dealing, any act as the board of directors . . . shall be presumed to be in the best interests of the corporation. *In assessing whether the standard set forth in section [] has been satisfied, there shall not be any greater obligation to justify, or higher burden of proof with respect to, any act as the board of directors, … relating to or affecting an acquisition or potential or proposed acquisition of control of the corporation than is applied to any other act as a board of directors*, any committee of the board or any individual director. Notwithstanding the preceding provisions of this subsection, any act as the board of directors, … relating to or affecting an acquisition or potential or proposed acquisition of control to which a majority of the disinterested directors shall have assented shall be presumed to satisfy the standard set forth in section [], unless it is proven by clear and convincing evidence that the disinterested directors did not assent to such act in good faith after reasonable investigation.[221]

There are variants of this provision in the statutes of the different states, but the common theme is that when imposing defensive measures in tender offers, directors will be subject to the ordinary and universal fiduciary duties of care, loyalty and good faith that are ordinarily applicable to director's actions, based on the presumption that they are acting in the best interest of the company. The implicit corollary is that director actions in jurisdictions that have these defensive tactic statutes will be reviewed under the business judgment rule. One such case illustrates the point:

> IBSF is correct that, unlike Delaware, New Jersey has chosen not to apply heightened scrutiny to director action taken in defense against a proposed acquisition. N.J.S.A. 14A:6-1(3) states that *when faced with "any proposal or offer to acquire the corporation . . . the board of directors shall have no obligation to facilitate, remove any barriers to, or refrain from impeding the proposal or offer*."[222]

[220] The rules developed in Revlon and Blasius are offshoots of Unocal's enhanced scrutiny.
[221] 15 Pa. Cons. Stat. Ann. § 1715 (West) (emphasis added).
[222] IBS Fin. Corp. v. Seidman & Associates, L.L.C., 136 F.3d 940, 949 (3d Cir. 1998) (emphasis added).

Also, in Massachusetts, the court in responding to the agitation by the plaintiffs to apply the proportionality doctrine in *Unocal*, noted that it is not "wholly free … to innovate at pleasure," in essence stating that it had to follow the law of Massachusetts and not Delaware.[223] Accordingly, the court stated,

> *The standards set forth in Mass.G.L.c. 156B, secs. 32A and 65, with no additional or heightened judicial scrutiny, are the standards that apply to actions taken with respect to a shareholder rights agreement* of a Massachusetts corporate entity adopted pursuant to Sec. 32A, either directly or on a recommendation of a special committee of a board of directors, of which board a majority is independent and which special committee itself is made up solely of independent directors.[224]

When it comes to interfering with the shareholder franchise however, Delaware law is influential, even where enhanced judicial scrutiny is rejected:

> Neither the briefs of the parties, nor our researches, have identified New Jersey cases which have addressed the level of scrutiny to be applied to action by a board of directors intended to hamper the exercise by some shareholders of their franchise. Given the absence of pertinent New Jersey case law, the district court was, in our judgment, correct in concluding that New Jersey courts confronted with a case like the case at bar would look to Delaware case law.[225]

It should be noted that a few states also apply the Unocal standard, and it would be instructive to compare decisions outside applying the other standards of review. This will help in understanding whether it is possible to achieve the same goal using different methods.

Hanson Trust Plc v. ML SCM Acquisition, Inc.[226] involved the struggle for the acquisition of SCM, a New York corporation. Hanson Trust had made a tender offer for SCM, which SCM responded to by finding a white knight and entering into a merger agreement with Merrill Lynch.[227] Pursuant to the terms of the merger agreement, SCM

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[223] Seidman v. Cent. Bancorp, Inc., 030547BLS, 2003 WL 21528509 (Mass. Super. Jun. 30, 2003).
[224] *Id.* (emphasis added).
[225] *Supra* note 222, at 949.
[226] 781 F.2d 264 (2d Cir, 1986).
[227] Pursuant to the merger agreement, Merrill Lynch also launched a tender offer for SCM, a two-tier front end loaded offer, in which Merrill Lynch would acquire 80% of the shares of SCM for cash, and then the remainder of the shares would be acquired in a second step transaction and the consideration for those shares would be "junk-bonds." Under Delaware law, this is a classic coercive offer which the courts frown upon and it is almost certain that this type of defensive measure would have been found to be coercive and therefore unreasonable.

agreed to "lock up" certain of its assets for sale to Merrill Lynch at a pre-determined price, should a third party acquire more than one third of SCM's stock. Merrill Lynch exercised the lock-up option once Hanson Trust acquired 37.4%. Hanson Trust subsequently brought action to enjoin the lock-up option.

On appeal, the first item on the agenda for the Second Circuit was to determine the appropriate standard of review. According to the court, "SCM is a New York corporation and . . . the acts of its directors are to be considered in light of New York law. Under New York corporation law, a director's obligation to a corporation and its shareholders includes a duty of care . . . . In evaluating this duty, New York courts adhere to the business judgment rule . . . . " As to the burden of proof, the court stated further, "[a]lthough in other jurisdictions, directors may not enjoy the same presumptions per the business judgment rule, at least in a takeover context, *see, e.g.*, *Unocal* . . . , under New York law, the initial burden of proving directors' breach of fiduciary duty rests with the plaintiff."[228]

According to the court, the fact that the business judgment rule applied did not protect directors where there is sufficient evidence of a breach of fiduciary duty. The focus of the court's review turned on the directors' duty of care which accordingly requires directors to act with "reasonable diligence" in gathering and considering material information. The directors' process was confined to a three-hour late-night meeting at which they did not ask the appropriate questions with regard to valuation of the assets to be sold pursuant to the lock-up option or even the tender offer price, neither did they request a fairness opinion from their financial advisers. They simply relied on their advisers' opinion without adequately informing themselves. Having found that the directors had breached their duty of care for the foregoing reasons among others, the burden of proof then shifted to the board to justify its actions. The court was not satisfied with SCM's justifications and found that "the mere threat

[228] *Supra* note 226, at 273.

of the exercise of the [lockup] option . . . operates to coerce Hanson and other SCM shareholders into tendering for potentially less than optimal consideration . . . ."[229] Applying the business judgment rule, the court enjoined SCM and Merrill Lynch from exercising the lock-up option.

We can analyse this case using the 2-prong Unocal test to see if we reach the same result. Under Unocal, the directors would initially need to show that they believed there was a threat to corporate policy and effectiveness, by exercising good faith and reasonable investigation. The common threats that Delaware courts have recognised from the cases discussed earlier in this paper include inadequate value, a desire to remain independent, or a management plan for the long-term value of the company. In its deliberations, the SCM board never directly discussed the inadequacy of the Hanson Trust tender offer.[230] On this basis alone, the directors would fail the first prong of Unocal, not having shown the reasonable investigation required to conclude that the tender offer posed a threat.[231] With respect to the proportionality test of the 2nd prong, the directors must show that the lock-up option was not preclusive or coercive and that it fell within a range of reasonableness. The court had held that the effect of the lock-up option was to coerce the shareholders into tendering into the Merrill Lynch offer at a price less than the Hanson Trust tender offer. It is this kind of defensive measure which would be found to be unreasonable under Delaware case law, and which was in fact found to be so in *Revlon*, a case in which the court enjoined a similarly applied lock-up option albeit for a different reason.[232]

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[229] *Supra* note 226, at 283.
[230] *Supra* note 226, at 281.
[231] Of course, if Unocal was the standard to be applied, the directors would have made a great showing of how Hanson's tender offer was inadequate.
[232] In *Revlon*, 506 A.2d, 183, which also cites the present case, the court found the lock-up impermissible under the Unocal standard, because the duty of directors in that situation had changed from defending the company against a takeover to an auctioneer whose duty is to get the highest price possible, rather than playing favourites which is the effect of the grant of the lock-up option. I must clarify that the standard in *Revlon* applies in circumstances that are different from the typical Unocal scenario. Revlon applies when what began as a

This shows that simply by applying the business judgment rule, without resorting to proportionality review, a defensive measure may be found to be a breach of fiduciary duty. There is no reason for the business judgment rule to be as deferential as it is generally perceived to be.

defensive measure metamorphoses into the inevitable breakup of the company or leads to a sale or change of control.

After the trio of *Time, Inc.*, *Moore,* and *Unitrin*, the last of which was in 1995, there have been insinuations that Unocal is effectively dead.[233] In a particularly wordy opinion which traced the development of recent Delaware corporate law, Special Superior Court Judge Tennille of the Superior Court of North Carolina in *First Union Corp. v. SunTrust Banks, Inc.*, suggested that the Delaware Supreme Court by declining to apply the fiduciary duty analysis of Unocal and applying statutory interpretation instead, may be searching for a more predictable standard of review as an alternative to the now multifaceted standards of review that fiduciary duty analysis has evolved into under Delaware law. [234] To support his assertion, the judge referred to two cases decided by the Delaware Supreme Court,[235] to which we can now add a third after the *Omnicare* decision, to which the court declined to apply a fiduciary duty analysis, and applied statutory interpretation instead.

The first of such cases is *Brazen v. Bell Atlantic Corp.*[236] This case was about the validity of a $550 million termination fee contained in a merger agreement. The text of the merger agreement referred to the termination fee as "liquidated damages and not a penalty," but the plaintiff challenged its validity claiming that it was excessive and was aimed at coercing the shareholders to vote in favour of the proposed merger. The Chancery Court in upholding the termination fee availed the defendants of the presumptions of the business judgment rule, and the plaintiffs were unable to successfully rebut the presumption.[237] Although the Delaware Supreme Court reached the same conclusion as the Chancery, it

[233] Thompson and Smith, *supra* note 21, at 286.
[234] 01-CVS-10075, 2001 WL 1885686 at *1 n.2 (N.C. Super. Aug. 10, 2001). Fiduciary duty analysis covers the entire gamut from the Business Judgment Rule, to Unocal, Revlon, and Blasius. *But see*, Williams v. Geier where the Court applied the business judgment rule rather than the Unocal and Blasius analysis that the Chancery had applied.
[235] *First Union Corp.*, *supra* note 234.
[236] 695 A.2d 43 (Del. 1997).
[237] Brazen v. Bell Atl. Corp., CIV. A. 14976, 1997 WL 153810 (Del. Ch. Mar. 19, 1997) *aff'd on other grounds*, 695 A.2d 43 (Del. 1997). *See also*, In re IXC Communications, Inc. Shareholders Litigation, C.A. 17324, 1999 WL 1009174 (Del. Ch. Oct. 27, 1999) (where the Chancery applied the business judgment rule to deal protection devices).

employed a different approach relying instead on the liquidated damages analysis applicable in Delaware courts.[238] The Delaware Supreme Court chose to accept the literal wording of the agreement designating the $550 million fee as liquidated damages, and nothing else. According to the Court, liquidated damages provisions are not strictly determined under the business judgment rule otherwise the courts would not have developed the liquidated damages test which objectively analyses the reasonableness of the amount of applicable damages.

One thing stands out in this case: the Chancery Court reached its decision by applying the business judgment rule analysis regardless of the fact that the decisions in *Time, Inc.* and *QVC*, had determined that a Unocal analysis is applicable when considering deal protection devices. The Chancery had clearly rejected the idea that the termination fee was liquidated damages, which would have perhaps compelled it to apply the liquidated damages analysis. If therefore the fee was not liquidated damages, and was properly a termination fee, I believe the Unocal analysis should have been applied rather than the business judgment rule. On the part of the Delaware Supreme Court, neither of the fiduciary duty analyses under the business judgment rule nor Unocal was even discussed.

The second such case referred to by the *First Union Corp.* court is *Quickturn Design Systems, Inc. v. Shapiro*, where the board of directors of Quickturn amended the shareholder Rights Plan of the company in response to a tender offer and proxy contest launched by Mentor Graphics.[239] The amended Rights Plan would prevent any Mentor- elected board from redeeming the Rights Plan for a period of 180 days if such redemption would facilitate the acquisition of the company by Mentor Graphics (the “delayed redemption provision”). The Rights Plan amendment was in lockstep with a separate amendment to a provision of the

[238] *Brazen*, 695 A.2d at 47.
[239] 721 A.2d 1281, 1287 (Del. 1998).

bylaws which would effectively delay a shareholder-requested meeting for a period of between 90-100 days. The Chancery, applying Unocal found that although the board had reasonably determined a threat that the shareholders would in mistaken belief tender into the Mentor offer and elect a new board that would sell the company without the shareholders realising Quickturn's true value, the delayed redemption provision was held not proportional because it tended to coerce any newly elected board to evaluate Quickturn and provide alternative transactions to the shareholders before selling the company.[240]

On appeal, the Delaware Supreme Court would however take a different tack. Identifying also the element of coercion faced by a new board of directors, the Court decided to analyse the delayed redemption provision against the provisions of statute, and it found the provision to be invalid.[241] Specifically, the Delaware Supreme Court found that § 141(a) of the Delaware General Corporation Law confers upon every board of directors the full powers to manage the company, unless the certificate of incorporation of the company limits the authority of the board. Concluding that there was no such provision in Quickturn's certificate of incorporation, the delayed redemption provision was held invalid under that provision.

The Court did not stop there – it made an additional analysis of the delayed redemption provision. According to the Court, director's fiduciary duties change according to the particular context and usually cannot be estimated ahead of time. Therefore, a provision that pre-determines directors' actions could lead to the directors breaching their fiduciary duties in the future. Particularly with regard to takeover defensive measures, the Court said, "[i]n *Revlon*, this Court held that no defensive measure can be sustained when it represents a

[240] Notice the difference with the party bearing the effect of the coercion in this case; while the principle of coercion developed up until *Unitrin* was in relation to shareholder choice, this time around, it relates to directors' choice.
[241] A similar result was reached in Carmody v. Toll Bros., Inc., 723 A.2d 1180 (Del. Ch. 1998) where the Chancery held that a provision of the Rights Plan which permitted only the "continuing directors" to redeem a Rights Plan – the so-called "dead hand pill", was invalid by virtue of § 141(a) Delaware General Corporation Law.

breach of the directors' fiduciary duty. A *fortiori,* no defensive measure can be sustained which would require a new board of directors to breach its fiduciary duty."[242] It was solely in this context that the Delaware Supreme Court's addressed the issue of directors' fiduciary duties when applying takeover defensive measures.

It is apparent why the *Quickturn* decision would be befuddling. A bright line rule has been in existence since the decision in *Unocal* i.e. before the business judgment rule would apply to a board's defensive action in a takeover, the board must prove first that it reasonably believed there was a threat to corporate policy and effectiveness, and second that the defensive action was reasonable in relation to the threat.[243] Unless I am mistaken, the Quickturn board's bylaw and Rights Plan amendments were a defensive response to Mentor's tender offer. The default standard of review should have been Unocal, as the Chancery properly did. The Delaware Supreme Court did not even consider Unocal in reaching its decision, in such a clearly obvious case that begs for the application of Unocal!

Like *Brazen*, *Omnicare* involved the use of deal protection devices. Unlike *Brazen* where it avoided a Unocal analysis on a technicality, the Delaware Supreme Court in *Omnicare* reverted to a Unocal analysis of the deal protection devices used by the NCS board, and found them to be unreasonable by reason of being coercive.[244] The Court did not stop there however. After finding the deal protection devices unreasonable, the court found that "alternatively, they are unenforceable because they are invalid as they operate in this case."[245] Rendering its opinion, the Court stated that the combination of the voting agreements, the force the vote provision, and the lack of an effective fiduciary out clause, prevented the board from fulfilling its fiduciary duties to the minority stockholder when

[242] *Quickturn*, 721 A.2d at 1292.
[243] *See, e.g.*, *Unocal*, 493 A.2d at 955; *Moran*, 500 A.2d at 1356; *Revlon*, 506 A.2d at 180.
[244] See discussion of *Omnicare* on page 47.
[245] *Omnicare*, 818 A.2d at 936.

Omnicare presented its superior proposal.[246] Once again, the Court noted that a board's fiduciary duties apply even to indeterminable future events, preventing them from binding up their fiduciary responsibilities in the present. Regardless that an action is legal, like the combination of the force the vote and the voting agreements was, such action must conform to a board's fiduciary duties, otherwise they would be invalid.[247]

Reminiscent of its holding in *Quickturn*, the Delaware Supreme Court once again found that an otherwise legal action could be invalid if it prevented or had the potential to prevent directors from exercising their fiduciary duties. This is particularly instructive when we consider that this provision applies even where a board is empowered under the law to act the way it did. The Court realising how this could be perplexing to any observer, stated that such statutory provisions e.g. § 251(c) of the DGCL which permits force-the-vote transactions, are "presumptively valid in the abstract" and cannot "validly define or limit the directors' fiduciary duties under Delaware law or prevent the [NCS] directors from carrying out their fiduciary duties under Delaware law."[248] The Court explained that even the deliberations leading up to the amendments to § 251(c) explicitly provided that "the amendments are not intended to address the question of whether such a submission requirement is appropriate in any particular set of factual circumstances."[249]

A holistic appraisal of these three cases – *Brazen*, *Quickturn* and *Omnicare* – portends trouble in Unocal- land. It had been coming, what with the inconsistencies and conflicts that had been playing out, even right from the *Unocal* decision.[250] The Delaware Supreme Court's subtle shift from the enhanced judicial scrutiny is not without its concerns. When the Supreme Court starts to oscillate between law and equity, the clarity which it intends to foster

[246] *Id.*
[247] *Id.* at 937.
[248] *Id.* at 938.
[249] *Id.* at 937.
[250] *First Union Corp.*, 01-CVS-10075, 2001 WL 1885686 at *17.

by deviating from the enhanced judicial review is not thereby achieved. Then Vice-Chancellor Strine had this to say particularly with reference to the Supreme Court's decision in *Omnicare*: "this reasoning renders indistinct the line between law and equity by announcing that legally authorised action is, in any conceivable circumstance, somehow invalid."[251] Citing *Schnell v. Chris-Craft*,[252] the leading Delaware precedent in which it was first held that that lawful corporate action would not be upheld if it is inequitable, the Chancellor continued saying "if the General Assembly has decided that certain acts are legal, then presumably there must be circumstances when a board's decision to take those acts must be equitable."[253] Recall that the *Omnicare* board actions were legal, yet they were held invalid for being a breach of the board's fiduciary duty (in addition to being coercive).

So where does that leave the Unocal standard of review? While the critics think Unocal is dead,[254] recent decisions show that it is anything but. The Delaware Supreme Court went back to a pure Unocal analysis in the *Versata* case as recently as 2010.[255] However, a discussion of the current state of Delaware jurisprudence regarding Unocal requires a consideration of the recent *Airgas* cases.

Airgas Facts[256]

In February 2010, Air Products and Chemicals, Inc. ("Air Products") launched a public tender offer for all outstanding shares of Airgas, Inc. ("Airgas") at $60/share. The tender offer was the culmination of a process that began in late 2009 when Air Products first approached Airgas about a possible transaction. Airgas flatly rejected this offer as grossly

[251] Leo E. Strine, Jr., *If Corporate Action Is Lawful, Presumable There Are Circumstances in Which It Is Equitable to Take That Action: The Implicit Corollary to the Rule of Schnell v. Chris-Craft*, 60 BUS. LAW. 877, 902 (2004-2005).
[252] 285 A.2d 437 (Del. 1971).
[253] Stine, *supra* note 251, at 903.
[254] See *supra* note 233, and the accompanying text.
[255] See discussion of *Versata* at page 40 of this paper.
[256] 16 A.3d 48 (Del. Ch. 2011).

inadequate. Through several increases in the tender offer, Airgas directors kept rejecting the offer as inadequate. Air Products' onslaught on Airgas was on two fronts – the tender offer and a proxy contest which it commenced about a month after the tender offer. Each of these is discussed in turn below.

1. The Tender Offer

This was Air Products' primary method of gaining control of Airgas. After its final tender offer of $70 had been turned down by the Airgas board as being inadequate, Air Products brought an action for relief before Delaware Chancery Court seeking the Airgas board to remove its defensive measures, in particular its poison pill in order to allow the shareholders tender into the offer. Air Products presented quite an ingenious argument before the court stating that the business judgment rule and not Unocal should apply, because there was no "omnipresent spectre" that the directors were acting primarily in their self-interest since its nominee directors and the incumbent directors were acting in unison and had received advice from an investment banker requested by its nominees.[257] The Chancery wasted no time in shooting down this theory, stating that as long as a target board takes defensive action in response to a tender offer, Unocal would apply.

In an opinion which hinted that the Chancellor's hands were tied in reaching his decision,[258] it was held that the Airgas board had discharged its duties under the Unocal standard of review. With respect to the first prong i.e. finding through reasonable investigation that a threat to corporate policy and effectiveness existed as a result of the tender offer, the court found that the Airgas board had identified two threats: (i) the threat of

[257] *Airgas*, 16 A.3d at 92.
[258] See the Chancellor's statement in *Airgas*, 16 A.3d at 101 ("Thus, while I agree theoretically with former-Chancellor Allen's and then-Vice Chancellor Strine's conception of substantive coercion and its appropriate application, the Supreme Court's dictum in *Paramount* (which explicitly disapproves of *Interco*) suggests that, unless and until the Supreme Court rules otherwise, that is not the current state of our law.")

inadequate value; and (ii) the threat that the arbitrageurs who formed a large bloc of shareholders would tender into the offer thereby coercing the other shareholders to tender into the inadequate offer.[259] Concerning the proportionality prong, the court found the Airgas board's maintenance of the poison pill to be reasonable in relation to the threat because it was neither preclusive (the possibility of Air Products obtaining control of Airgas board was not "realistically unattainable"),[260] nor coercive (Airgas management was not cramming down a management sponsored alternative on the shareholders; rather it was simply trying to maintain the status quo and manage the company for the long term),[261] and it fell within a range of reasonableness.

2. The Proxy Contest

As part of its efforts to unseat the Airgas board in a proxy contest in 2010, Air Products nominated a slate of three directors for election at the next annual meeting of the company which was earlier scheduled to hold in August 2010 at the latest. Air Products also proposed to amend Airgas's bylaws to require Airgas to hold its 2011 annual meeting and all subsequent annual shareholder meetings in the month of January.[262] Airgas's response to the proxy solicitation was to amend its bylaw to push the 2010 annual meeting back by a month to September 2010 in order to "provide information to stockholders" before the annual meeting, as well as more time to "demonstrate performance of the company."[263] At the annual meeting in September, the Air Products nominees were elected to the board and the Air Products' bylaw proposals were accepted by a majority of the shareholders. After this meeting, Airgas immediately filed suit in the Delaware Chancery challenging the validity of a

[259] *Id.* at 105-106.
[260] *Id.* at 121-122.
[261] *Id.* at 113.
[262] While this was not the only proposed bylaw amendment, it is the only one relevant for the purpose of this analysis.
[263] *Airgas*, 16 A.3d at 73.

one of the bylaws which was passed at the annual meeting. Although the Chancery upheld the validity of the bylaw, what followed next at the appeal to Delaware Supreme Court is interesting because it reflects the analysis that the Delaware Supreme Court has found ways to rely on the application of law rather than a fiduciary duty analysis in reaching certain of its decisions.

The Airgas board argued that Article 5, Section 6 of its corporate Charter requires a supermajority vote to enact a bylaw that is inconsistent with the existing Article III of the bylaws.[264] Specifically, that Charter provision states:

> By-Law Amendments. Notwithstanding [] anything contained in this certificate of incorporation to the contrary, Article III of the By-Laws shall not be altered, amended or repealed and no provision inconsistent therewith shall be adopted without the affirmative vote of the holders of least 67% of the voting power of all the shares of the Corporation entitled to vote generally in the election of Directors, voting together as a single class.[265]

Therefore, since only a simple majority approved the enactment of the bylaw altering the time of the annual meeting, the bylaw was invalid.

The issue in the case stemmed from an interpretation of Article III of the bylaws. Air Products argued that the term of the directors terminated at the annual meeting in the third year following the year of their election and that there was no requirement that the directors should have served a full term before the annual meeting in which directors are to be elected could be held. The effect of the newly enacted bylaw would be to shorten the term of the directors coming up for election by as much as 8 months since the next annual meeting was

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[264] Article III of the Bylaws provides for the classified board of directors as follows, “Number, Election and Terms . . . . The Directors . . . shall be classified, with respect to the time for which they severally hold office, into three classes, as nearly equal in number as possible, one class to hold office initially for a term expiring at the annual meeting of stockholders to be held in 1987, another class to hold office initially for a term expiring at the annual meeting of stockholders to be held in 1988, and a third class to hold office initially for a term expiring at the annual meeting of stockholders to be held in 1989, with the members of each class to hold office until their successors are elected and qualified. At each annual meeting of the stockholders, the successors or the class of Directors whose term expires at the meeting shall be elected to hold office for a term expiring at the annual meeting of stockholders held in third year following the year of their election . . . .” Airgas, Inc. v. Air Products & Chemicals, Inc., 8 A.3d 1182, 1186 (Del., 2010).

[265] *Id.* at 1186.

to be held in January, barely 4 months after the last annual meeting held in September of the previous year. Airgas on the other hand argued that the annual meeting in which directors are to be elected could not be held until the directors have served a "full term" of three years.

The Chancery applied a strict interpretation of the statute[266]and the bylaws and held that there was nothing in the statute or the Bylaws that provided that annual meetings could only be held approximately one year apart, or set a minimum amount of time that must elapse between one annual meeting and the next one, or even for that matter defined what a "full term" connotes. The Delaware Supreme Court agreed with the Chancery that the wording of the bylaw was unclear as to the specific term of any class of directors. However, the Delaware Supreme Court chose to interpret the provision differently than the Chancery. First, it looked to Delaware precedents which while not dealing with the question of the term of directors, held that staggered boards serve a term of three years.[267] Next, the Court looked at the terms of the staggered boards of other companies; a solid majority of companies, whose bylaws contained language similar to the Airgas bylaws, would usually include in their proxy statements that the staggered board directors serve a term of three years.[268] Further, the court consulted the American Bar Association's Public Company Organizational Documents: Model Forms and Commentary, as well as other commentary, and concluded that the document also provided a three year term for staggered boards.[269] Finally, the court cited *Essential Enterprises v. Automatic Steel Products, Inc.* where the Delaware Chancery as far back as 1960 had found that the intention of § 141(d) of the Delaware General Corporation

[266] "The directors of any corporation organized under this chapter may ... be divided into 1, 2 or 3 classes; the term of office of those of the first class to expire at the first annual meeting held after such classification becomes effective; of the second class 1 year thereafter; of the third class 2 years thereafter; *and at each annual election held after such classification becomes effective, directors shall be chosen for a full term* as the case may be, to succeed those whose terms expire." (emphasis added) DEL CODE ANN. TIT. 8, § 141(d) (2010).
[267] Airgas, Inc. v. Air Products & Chemicals, Inc., 8 A.3d 1182, 1190 (Del. 2010).
[268] *Id.* at 1191.
[269] *Id.* at 1191-92.

Law was that a "full term" should be three years, and that the intention of the by-law in question was to frustrate the purpose of a staggered board.[270]

The Delaware Supreme Court thus found the new Airgas bylaw to be "invalid not only because it impermissibly shortens the directors' three year staggered terms as provided by Article 5, Section 1 of the Airgas Charter, but also because it amounted to a *de facto* removal without cause of those directors without the affirmative vote of 67% of the voting power of all shares entitled to vote, as Article 5, Section 3 of the Charter required."[271]

Once again we see how the Delaware Supreme Court invalidated an action that complied strictly with the law, by holding such action invalid for other reasons outside of a strict reading of the law. The choice of words of the Court is instructive: the bylaw "amounted to a *de facto* removal without cause" of the directors. A de facto removal is a removal in practice, which is different from a removal according to the law (*de jure* removal). There is a subtle message that although according to a strict reading of the law, the directors were not 'removed without cause,' as such is a technical term, but the effect of the bylaw enactment was in fact such a removal, and so could not be upheld.

Now, I will be the first to say that the proxy contest decision discussed above dealt with the interpretation of statute and various corporate documents, which are effectively contracts between the corporation and its members, and the members among themselves. It is not a case that lends itself to the application of the proportionality test of Unocal. However, the case was one step in a hostile takeover battle, which ultimately affected the outcome of the takeover battle. Therefore, the reasoning adopted in the case is relevant to an understanding of the current application of Unocal.

[270] 159 A.2d 288, 290-91 (Del. Ch. 1960).
[271] Airgas, Inc. v. Air Products & Chemicals, Inc., 8 A.3d 1182, 1194-95 (Del. 2010).

When the Delaware Supreme Court introduced the so-called element of balance which mandates defensive measures to be proportional to the threat posed by the tender offer, the Court may not have anticipated the various twists and turns which would attend the proportionality prong of a Unocal review over time. At this point, it is uncertain why there was ever a need for a proportionality prong in the first place. If indeed proportionality now means that a defensive measure is not to be preclusive, nor coercive, the Chancellor's statement in *Airgas* speaks volumes: "But what seems clear to me, quite honestly, is that a poison pill is assuredly preclusive in the everyday common sense meaning of the word; indeed, its *rasion d'etre* is preclusion—to stop a bid (or *this* bid) from progressing. That is what it is intended to do . . . ."[272] In fact, that is what any defence to a hostile takeover is supposed to do – prevent the takeover from occurring. So, the dichotomy of approving the duty of directors to defend against hostile takeovers on the one hand, while mandating the proportionality of defensive measures on the other hand is in itself, the reason why there has been such tension in the application of the proportionality prong. Chancellor Chandler captured this sentiment perfectly when he said as follows:

> Our law would be more credible if the Supreme Court acknowledged that its later rulings have modified *Moran* and have allowed a board acting in good faith (and with a reasonable basis for believing that a tender offer is inadequate) to remit the bidder to the election process as its only recourse. The tender offer is in fact precluded and the only bypass of the pill is electing a new board. If that is the law, it would be best to be honest and abandon the pretense that preclusive action is *per se* unreasonable.[273]

In my opinion, this is not necessarily an undesirable result, all things considering. In fact, I daresay that this would be a step in the right direction, and the Supreme Court has said it in all sorts of ways. Even in *Quickturn* where the Supreme Court struck down a defensive measure, it did so for reasons other than Unocal's proportionality standard. It would do

[272] *Airgas*, 16 A.3d at 120.
[273] *Id.* at 122 n. 480 and its accompanying text.

Delaware corporate law good if it were to retrace its steps to pre-Unocal days, and analyse how the law was applied, determine what mischief Unocal was trying to address, analyse what if any, progress can be attributed to the Unocal standard and especially the proportionality prong. If Unocal is found not to have been satisfactory, what are the alternative doctrines outside Unocal-land which have had a measure of success in addressing the issues which Unocal purports to address? Where necessary, these doctrines can be adjusted for subsequent application in Delaware. I will address each of these in turn.

Pre-Unocal – Before Unocal, there was the business judgment rule, the entire fairness standard, and then there was *Cheff*. There were also the fiduciary duties of care, good faith and loyalty which directors owe to the shareholders and the company they oversee, and which when properly applied directors' actions could be scrutinised. It is on the foundation of these fiduciary duties that the business judgment rule developed to wit: absent a showing of a breach of fiduciary duty, directors are presumed to have acted in the best interest of the company and its shareholders. On the other end of the spectrum, the entire fairness test was developed to place a restraint on directors in certain situations where they face a conflict of interest, in which case it cannot be certain that they would be true to their fiduciary duties. As the court in *Weinberger v. UOP, Inc.* put it:

> [W]hen directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain . . . . The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.[274]

It was only in this extreme circumstance that the directors of a company found themselves deprived of the presumption of the business judgment rule.

[274] 457 A.2d 701, 710 (Del. 1983).

Cheff thus came about to deal with a situation where the directors faced a conflict of interest which didn't rise to the level of straddling both sides of a transaction. The conflict this time had to do with the possibility of directors losing their jobs as a result of a proposed takeover of the company leading the directors to take defensive action to prevent the takeover e.g. by paying "greenmail" as was the case in *Cheff*. The *Cheff* test therefore obligated the directors of a company employing defensive measures against a hostile takeover to prove that the primary purpose of the defensive measure was the company's interest, based on a reasonable belief that the threatened takeover was a danger to corporate policy and effectiveness.[275]

Thus, like the entire fairness standard, directors facing a threat to their control bore the burden of proof, except that the burden of proof introduced in *Cheff* was less stringent. Nonetheless, there was dissatisfaction with the primary purpose test of *Cheff*.[276]

What mischief was Unocal addressing? – The mischief which the *Unocal* court addressed was "the omnipresent spectre that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders,"[277] in the face of a pending takeover bid. This mischief is the same the *Cheff* court had considered i.e. conflict of interest in takeover situations.

Unocal's novelty – The novelty of the Unocal standard was the proportionality prong that is, the requirement that a defensive measure must be reasonable in relation to the threat posed by the takeover bid. While hailing *Unocal* as "the most innovative and promising case in our recent corporation law," Chancellor Allen noted that the two-part Unocal standard of review promised a "more realistic, flexible and, ultimately, more responsible corporation

[275] *Cheff*, 199 A. 2d at 504-05.
[276] See *supra* note 59, at 76.
[277] *Unocal*, 493 A.2d at 954.

law."[278] This is of course was a reference to the previous attempt in *Cheff*, to devise an appropriate standard for evaluating directors' action in defending against tender offers. Nonetheless, the Chancellor warned that that when not applied properly, it could lead to the "well-made fabric of the business judgment rule," being undermined.[279]

For one reason or the other, Unocal has not lived up to its early promise, not necessarily because it was not an innovative standard of review, but because it did not change the outcome of takeover battles – not one defensive measure has been struck down by the Delaware Supreme Court on a finding that such measure is disproportionate to the threat of the takeover bid.[280] In my own thinking, there is not much worth in a standard of review which leads to the same result as a previous standard of review. Why did the Delaware Supreme Court feel compelled to establish a different standard where even in the case where the standard was developed, i.e. *Unocal*, the holding in the case could have been reached using existing principles? I have heard of two reasons why the Unocal test may not be ineffective after all[281]: the first is that the Unocal standard does have a deterrent effect on what would have otherwise been the unrestrained power of directors to prevent takeovers by all means. Being a fact intensive standard of review, the directors are forced to make a convincing case, initially that there is a legitimate threat to the company as a result of the threatened takeover, and next they have to justify the defensive measure as being proportionate to the threat. While this may be the case, the fact is that it is the first prong of Unocal that requires the directors to carry out a reasonable investigation, which ultimately results in the numerous meetings, and the hiring of professionals to advise on the transaction, which the courts have come to see as the hallmark of reasonable investigation leading to the determination of a threat. It should be noted however that the requirement of reasonable

[278] *Interco*, 551 A.2d at 796.
[279] *Id.*
[280] The Quickturn defensive measure was rejected for being invalid, and not based on a Unocal analysis.
[281] In a discussion with Professor Robert Clark, Harvard Law School M&A professor.

investigation was not the innovation in *Unocal*, as this was already a requirement in *Cheff*.[282] The proportionality prong has been whittled down to a mere showing that the defensive measure falls within a range of reasonableness, which surely cannot be a tough test to pass.

The other reason given for the utility of the Unocal standard is that it facilitates compromise between directors of the target company and the potential acquirer. This is in the sense that the directors of the target company, lest they be found to have acted unreasonably, simply use the defensive measure as a bargaining chip to negotiate a better payday for the shareholders. Rather than rebuff overtures indefinitely and risk their actions being found to be unreasonable, the directors simply hold out as long as they can until they reach a more satisfactory offer price, which they eventually recommend to the shareholders.

Unocal Alternatives – Due to the fact that there will always be a conflict of interest whenever there is a tender offer and defensive measures are applied, there remains an obligation to find a standard of review that properly determines when directors are acting solely in their own self-interest when instituting a defensive measure. As seen throughout this paper, Unocal is not without its problems. In the absence of Unocal, what other standard could apply? There isn't just one standard which can apply in the place of Unocal, but a number of standards depending on the facts of the case. All these standards already exist in one form or another – e.g. the Business Judgment Rule, *Revlon*, *Blasius*. The business judgment rule would be the default applicable standard. Even in a takeover situation where directors have imposed defensive measures, the business judgment rule deftly applied would sniff out the director's improper actions. The only modification to the traditional business judgment rule which would be needed in the takeover context is to place the initial burden of proof on the directors such that they onus is on them to show that they have not breached any of their fiduciary duties of care, loyalty and good faith.

[282] *Cheff*, 199 A. 2d at 506.

This was the approach taken in *Cheff* save that in *Cheff*, the directors were required to prove that the primary purpose of their action was the corporation's best interest in order to discharge their burden of proof. It is the primary purpose part of the *Cheff* test that came under strong criticism for being too lax a standard. In place of the primary purpose test therefore, an alternative test would be to require the directors to show that the proposed takeover is not in the best interests of the company and the shareholders. The danger of course with this formulation is that it may tend to cause the judges to substitute their judgment of what the best interest of the company is, for that of the directors.

Nevertheless, discharging this burden will require the directors to be creative in devising a defence. The defences would vary depending on whether the board of directors is "just saying no," or whether they have approved an alternative plan for the company. Where the defence is "just say no", then the directors would need to prove either inadequate value, show that the takeover will be harmful to other constituents apart from the shareholders, or show that the company is on a progressive track that will yield benefits to the shareholders. This is largely the approach that was taken in the *Airgas* case. There, the directors were able to prove inadequate value and could show that the company was on an upward trajectory, which the takeover could scuttle. This is an approach that apparently worked. Just one year after the Delaware Chancery ruled in favour of Airgas after the Airgas board had turned down Air Products' $70 final offer as being inadequate, Airgas stock was trading at more than $80 per share![283] In addition to proving inadequate value, the Airgas board was able to prove the value inherent in the company, so much so that the new directors appointed at the behest of Air Products were sold on Airgas' prospects.[284]

[283] As at February 22nd 3:52pm EST, the Airgas was trading at $80.98 per share. MORNINGSTAR, http://quote.morningstar.com/Stock/s.aspx?t=ARG (last visited Feb. 22, 2012).
[284] *Airgas*, 16 A.3d at 83.

In the alternative, where the company has decided to adopt an alternative transaction or a restructuring to challenge the takeover bid, the directors will need to prove that the restructuring plan has greater potential or presents less of a threat to the company than the potential takeover. The burden would then shift to the tender offeror to prove that its plan for the target company is a better plan. While the judge need not substitute its judgment in deciding which the better business plan is, the incumbent directors' plan has to be appear convincing to a reasonable man. With this plan, rather than determining the proportionality of the alternative transaction, the court would only have to compare the merits of the plan against the tender offeror's plans, and this could avoid the uncertainty which has dogged Unocal since its origin. The danger of course with this plan is that if not carefully negotiated, the courts may be moving too close to making business decisions which is certainly not the intent.[285]

The other fiduciary duty standards will apply in their peculiar circumstances. First, as discussed earlier the shareholders' franchise cannot be subjugated without a showing of compelling justification, as held in *Blasius*. Thus if a defensive measure consists of a strategy that interferes with the shareholders' right to vote e.g. on the appointment of directors, such a defensive measure will not be sustained under the principle in *Blasius*. Second, where a defensive measure is a sale to a white knight or an auction of the target company, then the directors are bound by *Revlon* to seek the highest price possible under the circumstances.

[285] In addition, some feel that the shareholders are in a better position to be making this decision.

CONCLUSION

Crafting a judicial standard of review of directors' defensive actions in a hostile takeover that satisfies the shareholder primacy as well as the director primacy camps will take some inventiveness. In the end, it simply boils down to allocation of powers within the company: should the directors or the shareholders be the ultimate determinant of when and how a company gets sold?

One thing is clear however, Delaware judiciary has not gotten it right with Unocal. There needs to be a clearer and a more consistent and coherent standard which parties can rely on, and at the same time, the court should not put itself in the position of deciding what is best for a company. It certainly is a fine balance to maintain, but it can and has to be done. The court can and ought to retrace its steps in order to discover the point at which the rope got frayed. Going back in order to move forward is progress.