Unocal Revisited: No Tiger in the Tank

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I. INTRODUCTION

In 1985, the Delaware Supreme Court decided the case of *Unocal Corp. v. Mesa Petroleum Co.*,[1] and announced that when a board of directors acts to derail a hostile takeover, its actions will be subject to heightened scrutiny.[2] The Court recognized that directors have an "inherent conflict" of interest in such situations and may favor their own interests over that of the shareholders.[3] In light of this conflict, the Delaware court said that, if challenged, the directors have the burden of proving that they acted because they perceived a threat to the corporation and that the defensive actions that they took

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1. 493 A.2d 946 (Del. 1985).

2. *Id.* at 954.

3. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995) (citations omitted). This would seem to implicate the duty of loyalty. The Court, however, has been reluctant to so characterize a challenge to board action under the *Unocal* case. *See In re* Santa Fe Pac. Corp. S'holder Litig., 669 A.2d 59, 67 (Del. 1995) ("Revlon and Unocal and the duties of a Board when faced with a contest for corporate control do not admit of easy categorization as duties of care or loyalty.").

were reasonable, or proportional, in relation to the threat posed.[4] As the Delaware judiciary has the reputation of favoring corporate management in litigation,[5] the *Unocal* decision became an immediate source of scholarly comment and skepticism.[6] In particular, some scholars questioned whether *Unocal* really did mark a change in law, or whether subsequent interpretations of the decision would demonstrate that it lacked substance.[7]

Professors Gilson and Kraakman, in their 1989 article on *Unocal*, proposed that the Delaware courts engage in a serious analysis when the issue of proportionality is presented.[8] In their view, earlier Delaware cases reflected an unwise judicial deference to board action, requiring only that the board demonstrate some threat to corporate policy.[9] If the board could carry that light burden, it seemed that the Delaware courts did not inquire further; the action taken would be judged by the relatively benign business judgment rule test.[10] The authors expressed skepticism of defensive maneuvers substantiated only by assertions that the price offered was "grossly inadequate" and argued that courts should as well.[11] For Professors Gilson and Kraakman, *Unocal* presented the hope that Delaware courts would do more in the future. In particular, they proposed that when the only threat presented was one of "substantive coercion," that is, an allegedly inadequate price, the board should have the burden of showing why, how, and when their alternative will yield a better return for shareholders.[12]

Delaware jurisprudence since *Unocal* reveals that, despite the promise articulated in that case and the urgings of commentators, the Delaware Supreme Court has been reluctant to interfere with board decisions, at least where a majority of the board consists of independent directors. In no case has the Supreme Court held that a defensive

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4. *Unocal*, 493 A.2d at 955. This rule makes it difficult for defendant directors to dispose of a claim under *Unocal* with a motion to dismiss under rule 12(b)(6). *See Santa Fe Pac. Corp.*, 669 A.2d at 71-72.

5. *See* Mark J. Loewenstein, *Delaware as Demon: Twenty-Five Years After Professor Cary's Polemic*, 71 U. COLO. L. REV. 497, 510 (2000) (reciting Professor Cary's view); *see generally* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1991).

6. *See generally* Eric Grannis, Note, *A Problem of Mixed Motives: Applying* Unocal *to Defensive ESOPS*, 92 COLUM. L. REV. 851 (1992); Gregory S. Schaer, Comment, Blasius Industries, Inc. v. Atlas Corp.: *Closer Scrutiny of Board Decisions Under the "Compelling Justification" Standard*, 16 DEL. J. CORP. L. 639 (1991); Gregory W. Werkheiser, Comment, *Defending the Corporate Bastion: Proportionality and the Treatment of Draconian Defenses From* Unocal *to* Unitrin, 21 DEL. J. CORP. L. 103 (1996); Robert J. Klein, Note, *The Case of Heightened Scrutiny in Defense of the Shareholders' Franchise Right*, 44 STAN. L. REV. 129 (1991); Daniel S. Cahill and Stephen P. Wink, Note, *Time and Time Again the Board is Paramount: The Evolution of the* Unocal *Standard and the* Revlon *Trigger Through* Paramount v. Time, 66 NOTRE DAME L. REV. 159 (1990).

7. Chancellor Allen seemed to believe that *Unocal* was significant, observing in one case that *Unocal* was "the most innovative and promising case in our recent corporation law." Capital City Assoc. Ltd. P'ship v. Interco, Inc., 551 A.2d 787, 796 (Del. Ch. 1988).

8. Ronald J. Gilson and Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 274 (1989).

9. *Id.* at 249.

10. *Id.*

11. *Id.* at 268.

12. Gilson & Kraakman, *supra* note 8, at 268. By insisting that target management be called upon to justify the assertion that they can provide more value to the shareholders, a number of benefits can follow. For instance, the authors Gilson and Kraakman speculate that such a requirement would reduce management's incentives to resort to preclusive defenses and limit its ability to defend in the future if its plans do not produce the results that they promised. *Id.* at 269.

maneuver was disproportionate to the threat posed. Four of the court's most recent decisions interpreting *Unocal*, *Paramount Communications, Inc. v. Time Inc.*,[13] *Unitrin, Inc. v. Am. Gen. Corp.*,[14] *Williams v. Geier*[15] and *Quickturn Design Sys., Inc. v. Mentor Graphics Corp.*[16] each give a narrow reading to *Unocal*. Moreover, in two of these cases (*Unitrin* and *Quickturn*), the Supreme Court rejected conclusions of the Court of Chancery that *Unocal* required reversal of the defensive action of the board of directors.[17] While some Court of Chancery decisions seem to support a more robust reading of *Unocal*,[18] the opportunity was there to decide them on a basis other than the fiduciary principles announced in *Unocal*. The most recent of these Court of Chancery decisions, *Chesapeake Corp. v. Shore*,[19] illustrates the lack of utility of the *Unocal* decision. The thesis of this Article is, therefore, that *Unocal* has proved to be a toothless tiger, affording no protection for shareholders from the defensive actions of their board of directors beyond that provided in pre-*Unocal* cases. Moreover, *Unocal* has not afforded any protection to a bidder acting in good faith to acquire the stock of a publicly-held corporation. Rather, it has done just the opposite: by limiting an examination of a board's defensive actions to whether the target has breached its fiduciary duties to the target shareholders, and then articulating a test that strongly favors directors, the Delaware courts have ignored any potential interests of the bidder in acquiring the target.[20]

The weakness of the *Unocal* doctrine in limiting board action stands in contrast to the jurisprudence developed under *Unocal's* first cousin: the *Revlon* doctrine. *Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*[21] and its progeny[22] establish that when

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13. 571 A.2d 1140 (Del. 1990).

14. 651 A.2d 1361 (Del. 1995).

15. 671 A.2d 1368 (Del. 1996).

16. 721 A.2d 1281 (Del. 1998).

17. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1391 (Del. 1995); Quickturn Design v. Mentor Graphics Corp., 721 A.2d 1281 (Del. 1989) (affirming Court of Chancery).

18. *E.g.*, Chesapeake Corp. v. Shore, 771 A.2d 293 (Del. Ch. 2000) (adopting a bylaw to limit the ability of shareholders to amend bylaws is unreasonable under *Unocal*); ACE Ltd. v. Capital Re Corp., 747 A.2d 95 (Del. Ch. 1999) (limiting ability of board to consider other offers through merger agreement may constitute an unreasonable defensive measure under *Unocal*—discussed *infra* at note 176 and accompanying text); Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227 (Del. Ch. 1988) (adopting restructuring plan that gave management control of the company, but value to shareholders was inferior to takeover offer and no choice of offers was given to shareholders); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986) (coercing shareholders to tender was a disproportionate response under *Unocal*) (discussed *infra* at note 99 and accompanying text).

19. 771 A.2d 293 (Del. Ch. 2000). *See generally* Mark J. Loewenstein, Chesapeake v. Shore*: The Delaware Court Considers Defensive Bylaw Amendments*, 8 CORP. GOV. ADVISOR 9 (March/April 2000).

20. *See generally* Miriam P. Hechler, *Towards a More Balanced Treatment of Bidder and Target Shareholders*, 1997 COLUM. BUS. L. REV. 319 (1997); Mark J. Loewenstein, *Toward an Auction Market for Corporate Control and the Demise of the Business Judgment Rule*, 63 S. CAL. L. REV. 65 (1989) (discussing the interest of bidders apart from the interests of shareholders).

21. 506 A.2d 173 (Del. 1986).

22. *See, e.g.*, *In re* Santa Fe Pac. Corp. S'holders Litig., 669 A.2d 59, 71 (Del. 1995) (holding that plaintiffs failed to allege that after merger control would not remain "in a large, fluid, changeable and changing market" and absent such allegation plaintiff's *Revlon* claim fails); Paramount Communications Inc. v. QVC Network, Inc., 637 A.2d 34, 46 (Del. 1993) (describing how control shifted to acquirer; board obligated to reasonably obtain best value for shareholders); Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1290 (Del. 1994) (holding that *Revlon* duties attach in at least three circumstances: (i) where corporation initiates active bidding to sell or break up itself, (ii) where, in response to bid, corporation abandons long-term strategy

change of control of a corporation is inevitable, whether as a result of a decision of the corporation's board of directors or otherwise, the board acquires a fiduciary duty to obtain the best price for its shareholders.[23] A necessary corollary of this doctrine, under which the board becomes the auctioneer for the company, is that a board cannot favor one bidder over another.[24] This doctrine thus fully protects the interests of a potential acquirer as well as those of the target shareholders, as the courts carefully scrutinize the actions of the target board of directors. The *Revlon* doctrine in fact reflects a healthy skepticism of board action, a skepticism that is somewhat ironic. In a *Revlon* situation, the board's future is often sealed: whatever happens, the directors will lose their board seats. Nevertheless, the courts scrutinize their actions with relatively little deference.[25] By comparison, a successful defense by a board against a single bidder receives a lower level of scrutiny, despite the more obvious conflict of interest on the board. *Unocal*, when announced, suggested otherwise, but this has not proven to be the case.

If, indeed, the Delaware Supreme Court has narrowed the reach of *Unocal*, then two important consequences result. First, bidders must focus their attention on other doctrines if relief is to be obtained. *Blasius Industries, Inc. v. Atlas Corp.*[26] and *Schnell v. Chris-Craft Industries, Inc.*[27] are the obvious candidates, and this Article concludes with some thoughts on those cases. Second, the weakness of the *Unocal* doctrine means that the success of a takeover is heavily dependent on the possible success of a proxy fight. This, in turn, suggests that the Delaware courts should be particularly protective of shareholder democracy, not only in assuring the fairness of the election process, but also in assuring that shareholders have the right, on their own initiative, to amend the corporate bylaws.

After a brief reprise of *Unocal* itself, this Article proceeds with an analysis of the leading pre- and post-*Unocal* cases and then considers the *Chesapeake* case.[28] The Article then concludes with some thoughts on shareholder democracy.

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and adopts strategy that might result in breakup of the company, and (iii) where transaction contemplated by the board would result in a change of control); Paramount Communications Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989) (holding that no duty applies when control remained with the public shareholders); Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1287-88 (Del. 1989) (finding that while a market check is generally necessary for a board to discharge its *Revlon* duties, under the circumstances of this case a market check was not required); Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1055 (Del. Ch. 1997) (finding that creating a control block, where one did not exist before, triggers *Revlon* duties).

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

24. Unlike *Unocal*, *Revlon* and its progeny clearly did effect a change in Delaware law. Compare to *Revlon*, for instance, the decision in *Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980) (discussing a board decision to merge with white knight protected by business judgment rule).

25. A pre-*Revlon* case, which demonstrates the effect of *Revlon*, is *GM Sub Corp. v. Liggett Group, Inc.*, No. CIV.A.6155, 1980 WL 6430 (Del. Ch. April 25, 1980) in which the court refused to enjoin the sale by a target company of its key subsidiary to thwart a pending tender offer. *Id.* at 2. Had *Revlon* applied, a court might have viewed the target's actions as a break-up of the company, obligating the directors to maximize shareholder values.

26. 564 A.2d 651 (Del. Ch. 1988).

27. 285 A.2d 437 (Del. 1971).

28. The purpose of this Article is not to review all of the decisions that interpret the *Unocal* case. Rather, because the recent Delaware Supreme Court cases discussed in this Article accurately reflect the current attitude of the court regarding *Unocal*, the Article's objective is to capture the essence of the Delaware jurisprudence by focusing on a few significant decisions, especially those decided in the past several years. For a more complete description of all of the decided cases, see Eric A. Chiappinelli, *The Life and Adventures of* Unocal*—Part I: Moore the Marrier*, 23 DEL. J. CORP. L. 85 (1998).

II. *UNOCAL CORP. V. MESA PETROLEUM CO.*—A STANDARD ANNOUNCED

Unocal involved an unsolicited two-tiered tender offer[29] by Mesa Petroleum for thirty-seven percent of the outstanding shares of common stock of Unocal.[30] If successful, Mesa would have owned a bare majority of Unocal's common stock.[31] Mesa promised to acquire the balance of Unocal's shares in a merger in which Unocal shareholders would receive high yield, or "junk," bonds equal in value to the fifty-four dollars offered in the tender offer.[32] The Unocal board, which was dominated by independent, outside directors, responded with a scorched earth defense: Unocal offered to purchase from its shareholders, other than Mesa, forty-nine percent of Unocal's outstanding shares for seventy-two dollars per share worth of senior debt.[33] Unocal's offer was contingent on the success of Mesa's offer.[34] The effect was both elegant and devastating: unless Mesa withdrew its offer, it would end up owning a company heavily in debt and unable to support the financing for its offer.[35] Mesa sued, claiming that the Unocal directors breached their fiduciary duties in adopting the defense.[36]

The Delaware Supreme Court, reversing a preliminary injunction issued by the Court of Chancery,[37] held that the board acted consistently with its fiduciary duties, even though the circumstances called for enhanced scrutiny of their actions.[38] The court noted that directors faced with a potentially unwelcome change of control have an "inherent conflict of interest," as they may lose their positions. Therefore, the court reasoned, prior to taking any defensive action, the directors must demonstrate that the bidder posed a threat to corporate policy or effectiveness.[39] Proof of this threat is "materially enhanced" if the board consists of a majority of independent, outside directors.[40] If the directors satisfy this test, the court will review the defensive action to determine whether it was "proportional" to the threat posed.[41] If so, the directors' decision will be accorded the protections of the business judgment rule; that is, the burden will shift to the plaintiff to demonstrate that the decision was irrational.[42] As defendants have already demonstrated

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29. In a two-tiered offer, the bidder typically makes an offer for a majority of the stock at a given price, with plans to purchase the balance in a merger or similar transaction. A two-tiered offer is sometimes characterized as coercive if the announced consideration in the second tier is less than that offered in first tier. In such circumstances, target shareholders may feel coerced to tender in response to the first tier bid to avoid having all of their shares purchased in the lower, second tier bid.

30. *Unocal*, 493 A.2d at 949.

31. *Id.*

32. *Id.* at 949-50.

33. *Id.* at 956.

34. *Id.*

35. *Unocal*, 493 A.2d at 956.

36. *Id.* at 957.

37. Mesa Petroleum Co. v. Unocal Corp., No. CIV.A.7997, 1985 WL 44691, at *1 (Del. Ch. May 13, 1985).

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

39. If no threat is present when the board takes an action, even one "defensive" in nature, its actions are judged by the business judgment rule, absent a conflict of interest. Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988) (discussed *infra* notes 51–54, 56–59 and accompanying text).

40. *Unocal*, 493 A.2d at 955.

41. *Id.* at 955.

42. Newell Co. v. Vermont Am. Corp., 725 F.Supp. 351, 372 (N.D. Ill. 1989).

that the defensive action was proportional to the threat, it seems unlikely that the plaintiff could prove that the action was irrational.

Much has been written about *Unocal* by courts and commentators, so that only few comments are in order here. Regarding the threat test, the courts have limited its applicability to cases that implicate a possible change of control of the corporation, because only then are the board's actions suspicious.[43] Thus, if the board challenges a proposed merger between two competitors because the resulting entity would threaten competition, the board's actions are protected by the business judgment rule. Within that context, the "threat" test has not proven to be a significant obstacle to defendant directors. Taken literally, the test could have meant that the bidder must pose a threat to the corporation *qua* corporation.[44] So interpreted, an example of a threat would be a bidder who proposed to loot the target corporation, an obvious threat to the corporation *qua* corporation. The test never meant that, however, and instead has included threats that affect shareholders *qua* shareholders, so that the threat test is satisfied if the bidder makes a tender offer at an "inadequate" price, even if the shareholders are under no compulsion to accept this offer.[45] The threat in this instance is that the shareholders may harm themselves by mistakenly tendering into an inadequate offer.

In addition to ruling that an inadequate price constitutes a threat, courts have been quite willing to accept the conclusion of the target board that an offer is inadequate, insisting on a minimal showing in this regard.[46] Indeed, nearly all cases now involve such threats. The threat posed by Mesa's offer for Unocal (the two-tiered offer that "coerced" shareholders to tender into the front end to avoid having their shares acquired at a lower price in the back end) is no longer part of the takeover lexicon.

Regarding the "proportionality" test, a review of the decisions suggests that the test is a red herring of sorts.[47] The test suggests a world in which a range of responses exists and directors must choose a response that is consistent with the nature of the threat.

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43. I.P. Phillips v. Insituform of N. Am., Inc., No. CIV.A.9173, 1987 WL 16285, (Del. Ch. Aug. 27, 1987). Chancellor Allen applied a *Unocal* analysis to a situation in which there was no threatened change of control. While the facts of the case are somewhat complex, the dispute centered around an attempt by the corporation's board to dilute the ownership interest and the control of a majority block by various means. No change of control was at stake and the court recognized that *Unocal* was not directly implicated. Nonetheless, the court treated *Unocal* as applicable and determined that the board's action was not justified by any threat posed to the corporation. (One might conclude that the principles that animate *Unocal* apply whenever the board takes action that affects control, even if no threat is present. This, too, suggests that *Unocal* really adds little to the jurisprudence applicable to board actions in control contests; those same principles apply outside of that context as well.) *Id.*

44. *See* Loewenstein, *supra* note 20, at 79-89 (discussing the presence of a threat). Of course, if a threat is identified to corporate policy, the board is justified in taking defensive measures to protect the corporation. *See* Newell Co. v. Vermont Am. Corp., 725 F.Supp. 351, 375 (N.D. Ill. 1989) (board justified in defending against threat to corporate policy).

45. The Court of Chancery has characterized the "threat test" as "simply a particularization of the more general requirement that a corporate purpose, not one personal to the directors," be served by the defensive action. AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 112 (Del. Ch. 1986).

46. *See, e.g.*, Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1388 (Del. 1995) (stating that unless a board's defensive actions are draconian and unreasonable, then the business judgment rule applies). While demonstrating the presence of a threat has not proven to be an obstacle in the Delaware courts, a federal district court applying Delaware law refused to defer to the board's judgment that a tender offer was inadequate. NCR Corp. v. AT&T Co., 761 F. Supp. 475, 499 (S.D. Ohio 1991).

47. *See infra* Part IV.A. (discussing the narrowing of the proportionality test).

Indeed the Delaware courts have so described the test. In fact, however, there are only two kinds of threats, those that merit a defensive action that will defeat the offer and those that do not. The *Unocal* court decided that the Mesa offer was of the former variety; the Unocal board thus was justified in taking an action that would compel Mesa to withdraw its offer.[48] Mesa's offer, which has been described as "coercive," has become the prototype of an offer that justifies a preclusive defense. Coercive in this context means that each shareholder feels compelled to tender. In the case of Mesa's offer, shareholders may have feared receiving junk bonds for all of their shares if other shareholders accepted Mesa's offer and the offer succeeded.[49] To protect its shareholders from the Mesa offer, the Unocal board was justified in forcing Mesa to abandon its offer.

The *Unocal* court did not explore alternatives to this defense that would allow Mesa to re-structure its offer to avoid its offending aspects. For instance, the court might have concluded that Unocal could take an action that would force Mesa to raise its bid or to remove its coercive aspects. Unocal might have made its offer conditioned on Mesa's failure to raise its offer to a certain price or its failure to commit to a second-step merger at a fair, cash price. Indeed, the court might have insisted that the Unocal board at least meet with Mesa to determine if it would agree to such changes. By implicitly rejecting any such obligation on Unocal's part, the court was sending a message that is only now becoming clear: a board never has to negotiate if it decides, in good faith, that a sale of the company is not in the company's best interests.[50] So put, the only "threat" that a board need identify is that a change of control might occur.

Finally, *Unocal* has an interesting procedural consequence: if the action of the directors is subject to heightened scrutiny, a case against them cannot be dismissed on the pleadings. *Grobow v. Perot*,[51] a case in which the Delaware Supreme Court held that *Unocal* did not apply, illustrates the importance of the heightened scrutiny test. In *Grobow*, shareholders of General Motors brought a derivative action challenging the celebrated buyout of H. Ross Perot's shareholdings in the corporation.[52] The plaintiffs complained of the excessive price paid and the board's motivation for the deal.[53] Procedurally, the case came to the Delaware Supreme Court on the defendants' motion to dismiss for failure to make a demand on the board or adequately allege demand futility.[54] If the directors' actions were subject to enhanced scrutiny, the plaintiffs would be able to withstand the motion because the complaint would raise a reasonable doubt that the

48. *See* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987). The Court similarly upheld the defense of Newmont Mining in response to a bid by a partnership, Ivanhoe Partners, led by T. Boone Pickens (who also led Mesa's attempt to acquire Unocal). Newmont essentially assisted its largest shareholder, Gold Fields, obtain 49.7% of Newmont's outstanding shares, blocking Ivanhoe's attempted takeover. *Id.* at 1336-38.

49. Under this analysis, any partial offer for a substantial stake in the target is coercive; target shareholders may view the possibility of holding a minority stake in a corporation with a controlling shareholder as unacceptable, because the possibility of a control premium in the future is eliminated. Moreover, the options of a controlling shareholder may also be troubling to a minority shareholder.

50. Kahn v. MSB Bancorp, Inc., No. Civ.A.14712-NC, 1998 WL 409355, at *4 (Del. Ch. July 16, 1998), *aff'd without publ'd opinion*, 734 A.2d 158 (Del. 1999).

51. *Grobow*, 539 A.2d 180 (Del. 1988).

52. *Id.* at 185.

53. *Id.*

54. *Id.*

directors were disinterested.[55] Indeed, a doubt concerning director disinterestedness is the reason that the court recognized the enhanced scrutiny test.

The enhanced scrutiny test did not apply in *Grobow*, however, because the board's actions were not in response to an identified threat. Instead, the directors of GM acted to remove a vocal critic of their policies who was causing them great embarrassment, and the cost of doing so was a "giant premium."[56] As no threat was present—in the sense of a potential change of control—the directors were presumed to have acted with disinterestedness.[57] Plaintiffs' allegations to the contrary were insufficient to raise even a doubt of their disinterestedness, because the allegations merely speculated on the board's motivations; the court insisted on more specificity in the plaintiffs' complaint.[58] Consequently, when a threat implicating a potential change of control is presented, the directors are presumed to lack disinterestedness, but in the absence of such a threat, the plaintiff bears a heavy burden to establish lack of disinterestedness.[59] Cases such as *Grobow* are highly protective of directors, as plaintiffs must allege with particularity facts that suggest lack of disinterestedness even before they have the opportunity to engage in discovery. By contrast, in *In re Santa Fe Pacific Corp. Shareholder Litigation*,[60] the Delaware Supreme Court reversed a lower court decision that had dismissed a *Unocal* claim on the pleadings. The Delaware Supreme Court held that the plaintiffs' pleading burden was a limited one; they only had to allege that the board adopted defensive measures in response to a threatened change of control.[61] It is fair to ask whether, aside from its procedural impact, *Unocal* has made a difference in the way the Delaware Supreme Court treats complaints of director misconduct. Part IV demonstrates, at least in the Delaware Supreme Court, that *Unocal*'s impact has been less than it might have been.

III. THE WORLD BEFORE *UNOCAL*

Takeovers and threats to corporate control were common before Mesa made its doomed offer for Unocal in 1985, but there was not a great deal of litigation that reached the Delaware Supreme Court involving those issues. For instance, *Bennett v. Propp*[62] is a 1962 decision which is often cited for the proposition that directors violate their fiduciary duty to the corporation when they cause the corporation to repurchase its shares in order to entrench themselves in control.[63] Unlike the cases that cite it, *Bennett* did not involve a

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

56. *Grobow*, 539 A.2d at 184.

57. *Id.* at 188.

58. *Id.*

59. *Id.* at 190.

60. 669 A.2d 59 (Del. 1995).

61. *Id.* at 71-72.

62. 187 A.2d 405 (Del. 1962).

63. *See* Johnson v. Trueblood, 629 F.2d 287, 293 (3rd Cir. 1980); Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964); Good v. Texaco, Inc., No. 7501, 1985 WL 11536 (Del. Ch. Feb. 19, 1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 181 (Del. 1985); Newell Co. v. Wm. E. Wright Co., 500 A.2d 974, 982 (Del. Ch. 1985); Shapiro v. Pabst Brewing Co., No. 7339, 1985 WL 11578, at *4 (Del. Ch. July 30, 1985); GM Sub Corp. v. Liggett Group, Inc., No. CIV.A.6155, 1980 WL 6430, at *1 (Del. Ch. Apr. 25, 1980); Petty v. Penntech Papers, Inc., 347 A.2d 140, 143 (Del. Ch. 1975).

greenmail[64] purchase undertaken to rid the corporation of a potential threat to control. Rather, it involved the unauthorized purchases by Sadacca, an officer of Noma Lites, of a substantial amount of Noma's stock because he feared a takeover by another corporation, American Screw.[65] When the Noma board learned of the purchases, one day before payment was due on the purchased stock, it ratified Sadacca's actions and authorized the borrowing of money to settle the purchases.[66] The court upheld the actions of the directors other than Sadacca (and one other director who was aware of his actions and did nothing to stop him), ruling that, under the circumstances, they acted in the best interests of the corporation to protect it from potential losses if the purchased stock were not paid for. As to Sadacca, however, the court ruled that he would be liable to the shareholders for any losses because the use of corporate funds to preserve control (as Sadacca admitted he was doing) was simply improper. *Bennett* thus stands for a simple proposition that remains unaffected by *Unocal*: an officer of a corporation cannot use corporate funds for a non-corporate purpose, in this case maintaining control.[67] *Bennett* also announced the shifting of the burden of proof to the directors that is often identified with *Unocal*. The court stated that when directors use corporate funds to purchase shares in response to a threat to control they "are of necessity confronted with a conflict of interest" and therefore "the burden should be on the directors to justify such a purchase as one primarily in the corporate interest."[68]

A second major pre-*Unocal* case is *Cheff v. Mathes*,[69] which did involve a greenmail purchase undertaken by the board of Holland Furnace Company. The board of Holland authorized the purchase after receiving advice that the seller, who by then had accumulated 17.5% of Holland's outstanding shares, posed a threat to the company, because if he acquired control he might liquidate the company or change its sales practices.[70] The latter possibility, was causing "unrest" among the company's employees. The presence of these threats, which the court claimed the defendant directors had the burden of demonstrating, justified the board's decision to repurchase the stock at a premium price.[71] The court's opinion suggests that because the board proved that there was a threat to the company, the repurchase served a corporate purpose; indeed, that is why the court required the directors to prove there was a threat.[72]

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64. "Greenmail" refers to the practice of a corporate raider who threatens a hostile takeover in order to induce the target board to repurchase the raider's shares of the target, generally at a premium over market and at a handsome profit to the raider.

65. *Bennett*, 187 A.2d at 407.

66. *Id.*

67. A more recent instance of this principle is in *WNH Investments, LLC v. Batzel*, No. CIV.A.13931, 1995 WL 262248, at *8 (Del. Ch. Apr. 28, 1995).

68. *Bennett*, 187 A.2d at 409.

69. 199 A.2d 548 (Del. 1964). To a similar effect is *Kors v. Carey*, 158 A.2d 136, 141 (Del. Ch. 1960) (finding that the directors' decision to purchase the shares of a raider was justified because the raider's business practices were so "entirely at odds" with those of the purchasing corporation).

70. *Id.* at 556.

71. *Id.* Somewhat remarkably, the Delaware Supreme Court reversed a finding of the Vice Chancellor that the directors were motivated to perpetuate their control of the company, finding, instead, that the record did not support the Vice Chancellor's conclusions. *Id.*

72. *Id.* at 556 and 558. The Vice Chancellor, in a 1985 opinion construing *Cheff*, reformulated its holding: "If the board's conduct served to accomplish a shift in the internal structure of the corporation in such a way as to transfer power from the shareholders to management, the board would be required to demonstrate the rational

The *Cheff* court did not consider the possibility that the presence of this threat did not motivate the repurchase and that it was just a pretext for the repurchase. In fact, there was a basis for so concluding, as the board minutes for the meeting that authorized the deal indicated that the shares were being repurchased for a stock option plan and said nothing about addressing a possible threat to the company.[73] As other evidence indicated that the stock option was not the motivating reason for the repurchase, the Vice Chancellor concluded that perpetuating control was the motivating factor.[74] The Supreme Court agreed that the stock option was not the reason for the repurchase, but held that parol evidence could supplement the minutes and that evidence supported the directors' argument that they were motivated to protect the corporation from potential harm.[75] They satisfied this burden, the court held, by showing good faith and reasonable investigation.[76] This standard was reiterated in *Unocal*. What is important about *Cheff*, as in so many Delaware cases, is not what the court said, but what it did. In the face of the lower court finding that the directors were motivated to perpetuate themselves in office, the Delaware Supreme Court upheld the directors' defensive actions, deferring to their conclusions that a threat was present.[77] Moreover, the Delaware Supreme Court refused to consider the merits of the board's judgment, because the board was independent and had engaged in a good faith investigation.

Thus *Bennett* and *Cheff* anticipate the standard announced in *Unocal*, except that *Unocal* added a factor: the defensive response must be reasonable in relation to the threat posed. In the post-*Unocal* world, Sadacca could easily avoid liability by following the process delineated in *Unocal*. A threat could easily have been found; the President of American Screw had notified Sadacca that he would ask his board to launch a tender offer for Noma. Had Sadacca brought the matter to the Noma board, that board could have found that the corporation's vulnerability to a change of control at least justified a poison pill.[78] And, while current SEC rules would have limited its ability to engage in the large open market purchases it undertook,[79] a self-tender would have passed muster under *Unocal*. In any case, post-*Unocal* (indeed, post-*Bennett*), any board knows that it

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purpose for its conduct, without a shifting in the burden of proof." Edelman v. Phillips Petroleum Co., No. 7899, 1985 WL 11534, at *3 (Del. Ch. Feb. 12, 1985). Presumably, the "rational purpose" would be the threat to the corporation. The notion that the burden of proof would not shift is also consistent with *Unocal*, which leaves with the plaintiff the burden of rebutting the presumption of the business judgment rule after the defendant directors demonstrate the presence of a threat.

73. 199 A.2d at 555.

74. *Id.* at 556.

75. *Id.* at 555.

76. *Id.*

77. *Id.* at 556.

78. Of course, the poison pill defense, approved by the Delaware court in *Moran v. Household Int'l*, 500 A.2d 1346, 1351-55 (Del. 1985), had not yet appeared at the time that *Bennett* was decided. In *Moran*, the court approved the board's adoption of a rights plan under the business judgment rule even without an existing threat to the corporation.

79. 17 C.F.R. § 240.13e-4 (2000). A tender offer by issuer requires compliance with detailed filing, disclosure and dissemination rules established by the SEC. In addition, no issuer can make a tender offer unless it is open to all other shareholders of the same class subject to the tender offer and the price paid to any shareholder according to the tender offer is the highest price paid to any other shareholder during the period of the tender offer. *Id.*

must identify a motivation other than entrenchment.[80] (As the cases below indicate, proving that there is a threat has not been an obstacle to directors.) The real issue in cases involving defensive actions is whether the response has been proportional to the threat. That test, too, has not been an obstacle and, in those few cases in which lack of proportionality determined the outcome, the case could have been decided on other, pre-*Unocal* principles.

IV. *UNOCAL* IN THE DELAWARE SUPREME COURT—THE STANDARD IS SHAPED

A. Paramount Communications, Inc. v. Time Inc.—*Threat Expanded; Proportionality Narrowed*

Paramount Communications, Inc. v. Time Inc.[81] tested both aspects of *Unocal*. The case arose when Paramount made a negotiable, all-cash, all-shares tender offer for Time—at a substantial premium above the then market price of Time—contingent upon Time and Warner Communications abandoning their merger agreement. In response, Time and Warner agreed that Time would make a tender offer for Warner shares, supported by Warner and protected by the "adoption of several preclusive defensive measures."[82] By restructuring the statutory merger as a tender offer, Time avoided a shareholder vote on the transaction. (Given the handsome premium offered by Paramount, the conventional wisdom was that the shareholders would reject the merger and tender into the Paramount offer.) Paramount sued to enjoin the purchase by Time of Warner shares, arguing that its offer did not pose a threat to Time and, if Time could identify a threat, that Time's response was disproportionate.[83] The Court of Chancery[84] and the Delaware Supreme Court ruled in favor of Time on both issues.

Drawing on a few Court of Chancery decisions,[85] Paramount argued that its all-cash, all-shares, fully negotiable offer at a price that shareholders would likely find acceptable could not pose a threat to the corporation or its shareholders. No shareholder would feel coerced to tender into the offer, and any inadequacy of the offer could be addressed through negotiations. The court rejected this argument, ruling that under *Unocal* the notion of threat was not so narrow. Rather, the emphasis is on whether the target board's evaluation, whatever that may have been, was the product of an

80. *See* Crane Co. v. Harsco Corp., 511 F. Supp. 294, 305 (D. Del. 1981) (a pre-*Unocal* case in which a defendant director conceded that the corporation's repurchase of shares was for the purpose of keeping the shares out of the hands of a potential acquirer; the court interpreted this as an impermissible motive); WNH Investments, LLC v. Batzel, No. CIV.A.13931, 1995 WL 262248, at *7 (Del. Ch. Apr. 28, 1995) (a post-*Unocal* case in which the court set aside an issuance of shares to corporate insiders because the purpose of the transfer was to perpetuate management's control).

81. 571 A.2d 1140 (Del. 1989).

82. *Id.* at 1154.

83. Presumably, a ruling in favor of Paramount on the motion to enjoin Time's tender offer would prompt Time to negotiate with Paramount and, eventually, drop its "preclusive defensive measures."

84. Paramount Communications, Inc. v. Time Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,284 (Del. Ch. Jul. 14, 1989).

85. *See* AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 113 (Del. Ch. 1986); Grand Metro. Pub. Ltd., PLC v. Pillsbury Co., 558 A.2d 1049, 1058 (Del. Ch. 1988); City Capital Assocs. v. Interco, Inc., 551 A.2d 787, 790-91 (Del. Ch. 1988).

appropriate process. The court eschewed an analysis of the substance of the board's decision: "Unocal is not intended to lead to a simple mathematical exercise . . . comparing the discounted value of Time-Warner's expected trading price at some future date with Paramount's offer and determining which is the higher."[86] Thus unburdened by a merit-based analysis, the court accepted Time's assessment that Paramount posed a threat because Time's shareholders "might tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefits [of a Time-Warner combination]."[87] The court also accepted Time's argument that the timing of Paramount's offer, made after Time had sent proxy materials to its shareholders on the original Time-Warner merger, was "designed to upset, if not confuse, the Time stockholders' vote."[88] Instead, the Time board had the authority to proceed with its "deliberately conceived corporate plan"[89] to combine with Warner, among the benefits of which was the protection of the "Time culture."[90]

The "threats" identified in *Paramount v. Time* were indeed mild in comparison to the threats identified in *Unocal*. Nevertheless, the court upheld the defenses, even though they had the effect of precluding Time shareholders from accepting the Paramount tender offer. This was justified, the court concluded, because Time's actions had as their goal "the carrying forward of a pre-existing transaction in an altered form."[91] In other words, the board's business judgment would be respected even if the shareholders might have preferred a different course of action. The implication of this ruling seems to be that if an independent board employs an appropriately deliberative process, its judgment to preclude the success of a hostile takeover will not be upset by the courts.[92] The Delaware Supreme Court, however, immediately backed away from this implication by noting that Paramount could make an offer for the combined Time-Warner company; that is, Time's

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86. *Paramount*, 571 A.2d at 1153. In a subsequent opinion, *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1373 n.13 (Del. 1995), the Court returned to this idea in a somewhat whimsical fashion. After stating in the text of the opinion that "Unocal is not intended to lead to a structured, mechanistic, mathematical exercise," the court cited and quoted from an academic article that sought to do just that. *Id.* George H. Kanter, Comment, *Judicial Review of Antitakeover Devices Employed in the Noncoercive Tender Offer Context: Making Sense of the Unocal Test*, 138 U. PA. L. REV. 225, 254-55 (1989). Apparently, the *Unitrin* court believed that reducing Unocal to a mathematical formula was so absurd that simply quoting a suggested formula would demonstrate its absurdity.

87. 571 A.2d at 1153. The court emphasized the importance of process in the next paragraph of the opinion, where the court considered Paramount's argument that the Time board had not adequately investigated Paramount's offer. After a cursory review of the evidence in the record on this claim, the court rejected Paramount's claim, stating that "[t]he evidence supporting this finding [that the Time board was not uninformed] is materially enhanced by the fact that twelve of Time's sixteen board members were outside independent directors." *Id.* at 1154.

88. *Id.* at 1153.

89. *Id.* at 1154.

90. *Id.* at 1148.

91. 571 A.2d at 1155.

92. The Delaware Supreme Court has, on many occasions, expressed this deference in abstract terms. *See, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1988) ("We have held that when a court reviews a board action, challenged as a breach of duty, it should decline to evaluate the wisdom and merits of a business decision unless sufficient facts are alleged with particularity, or the record otherwise demonstrates, that the decision was not the product of an informed, disinterested, and independent board."); *see also* Smith v. Van Gorkum, 488 A.2d 858, 872 (Del. 1985); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

actions did not entirely preclude Paramount's success and Time's shareholders were not precluded from receiving a control premium some time in the future. In any case, *Paramount v. Time* was an important victory for target boards. The court drained all substance from the threat test and refused to engage in a meaningful analysis of proportionality.

B. Unitrin, Inc. v. American General Corp.—*Proxy Fights are Preferred*

Unitrin, Inc. v. American General Corp.[93] arosc out of a hostile tender offer by American General for any and all of Unitrin's common shares at a thirty percent premium over market price, payable in cash. American General offered to negotiate both the price (if Unitrin could demonstrate greater value) and the structure of the offer (American General expressed a willingness to structure the deal as a tax-free merger). Unitrin rejected the tender offer and the offer to negotiate, concluding that the offer was "inadequate" and posed potential antitrust problems. The board then adopted three defensive measures—a poison pill, an advance notice bylaw, and a program to repurchase up to ten million of its shares of common stock, representing over nineteen percent of its outstanding shares (the "Repurchase Program")[94]—to respond to the identified threats. American General sued to enjoin the Repurchase Program. It obtained a preliminary injunction in the Court of Chancery, which ruled that the Repurchase Program was a disproportionate response to what it characterized as a "mild" threat. The Supreme Court reversed in an opinion that demonstrated a high degree of deference accorded to the decision of an independent board.

As in most cases, the issue of threat was simple. After noting that the Unitrin board had a majority of "outside directors,"[95] the court summarily accepted the lower court's finding that the board reasonably believed that American General's offer was "inadequate" and "was a threat to Unitrin's uninformed stockholders;"[96] that is, the stockholders did not fully appreciate Unitrin's long term value. The Court of Chancery had concluded that the antitrust concern was a "makeweight excuse" for the defensive measures and the Delaware Supreme Court apparently acquiesced in this finding, although it did not say so directly. It is interesting to note, however, that both courts readily deferred to the board's conclusion of price inadequacy while remaining skeptical of another board conclusion. The courts seemed unconcerned that a board that would fabricate an antitrust defense might also fabricate a concern over price inadequacy.

The bulk of the Delaware Supreme Court's opinion, however, was devoted to the proportionality issue. The Court of Chancery had concluded that the poison pill was an adequate response to the threat of price inadequacy. The Repurchase Program went too far in the lower court's judgment because it had the effect of giving the directors a veto

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93. 651 A.2d 1361 (Del. 1995).

94. *Id.* at 1370. An advance notice bylaw requires that shareholders must give the board sixty days notice prior to a scheduled annual shareholders meeting of an intent to present a question for consideration at the meeting or to put its own nominees up for election to the board. This advance notice gives the board time to prepare for controversial issues and avoids a surprise proxy contest intended to oust current members up for re-election.

95. The court defined an "'outside' director" as a "non-employee and non-management director." *Id.* at 1375.

96. *Id.*

over any American General merger. Upon completion of the Repurchase Program, the directors, as a group, would hold more than twenty-five percent of Unitrin's outstanding stock. As the Unitrin articles of incorporation required a vote of seventy-five percent of the outstanding shares to approve a merger of the company with a fifteen percent or more shareholder, American General argued it was unfairly disadvantaged by this action. The Court of Chancery agreed, concluding that if left unchecked, the Repurchase Program would chill "'any unsolicited acquirer from making an offer.'"[97] The Delaware Supreme Court disagreed with this conclusion and reversed.

The disagreement between the Delaware Supreme Court and the Court of Chancery centered on the role of the courts in reviewing a proportionality issue. The Court of Chancery opined that the poison pill afforded the board an adequate defense against a noncoercive, inadequate tender offer. The higher court held that the Court of Chancery exceeded its authority in so ruling. Rather, the judicial role is to determine first if a defensive action is "draconian," which the court described as "coercive or preclusive."[98] The Court was referring to defenses, like that in *AC Acquisitions Corp. v. Anderson, Clayton & Co.*,[99] that coerced the shareholders to tender into a self-tender in the same way that the Unocal shareholders may have felt coerced to tender into Mesa's two-tiered offer. If a defense does not rise (or fall) to the level of draconian, the defensive action need only be within a "range of reasonableness."[100] In explaining this test, however, the Delaware Supreme Court was less than clear. The court noted three factors that the Court of Chancery should take into account,[101] including whether the defensive response "was limited and corresponded in degree or magnitude to the degree or magnitude of the threat."[102] These factors cannot provide much guidance when one of them repeats the ultimate inquiry.

More telling, however, is the court's analysis, which focused on the extent to which the Repurchase Program would adversely affect American General's ability to wage a proxy contest for control of Unitrin. On this issue, the court noted that whether the board held twenty-three or twenty-five percent of the outstanding stock, American General would still be able to wage a successful proxy fight for control of Unitrin, especially since institutional investors owned forty-two percent of Unitrin's shares.[103] Thus, the

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97. *Id.* at 1378 (quoting the Court of Chancery).

98. 651 A.2d at 1367.

99. 519 A.2d 103 (Del. Ch. 1986).

100. *Unitrin*, 651 A.2d at 1388.

101.

> In considering whether the Repurchase Program was within a range of reasonableness the Court of Chancery should take into consideration whether: (1) it is a statutorily authorized form of business decision which a board of directors may routinely make in a non-takeover context; (2) as a defensive response to American General's Offer it was limited and corresponded in degree or magnitude to the degree or magnitude of the threat, (i.e., assuming the threat was relatively "mild" was the response relatively "mild?"); (3) with Repurchase Program, the Unitrin Board properly recognized that all shareholders are not alike, and provided immediate liquidity to those shareholders who wanted it.

Id. at 1389.

102. *Id.* For further discussion, see *infra* notes 81-84 and accompanying text.

103. *Id.* at 1383 (stating that the Repurchase Program "would not appear to have a preclusive effect upon American General's ability successfully to marshal enough shareholder votes to win a proxy contest"). Under

court concluded, "the Court of Chancery must determine whether Unitrin's Repurchase Program would only inhibit American General's ability to wage a proxy fight and institute a merger or whether it was, in fact, preclusive because American General's success would either be mathematically impossible or realistically unattainable."[104] Although strongly suggesting that the Repurchase Program was not a draconian defense and was proportional to the threat posed by American General, the Delaware Supreme Court nonetheless remanded the case to the Court of Chancery for a resolution of these questions, with a strong admonition that the lower court should not substitute its judgment for that of the Unitrin board, if the court finds that the Repurchase Program was "within the range of reasonable defensive measures available to the board."[105]

What seems most important about *Unitrin* is that the court's discussion of the viability of a proxy contest was in the context of a pending tender offer subject to a poison pill. It was a foregone conclusion that the tender offer could not succeed absent judicial intervention or a change of heart by the target board, so what might really have concerned the plaintiffs was that the defendants had stacked the deck in the looming proxy fight and might be spending up to $500 million or more on the Repurchase Program.[106] The court seemed unconcerned about a mere stacking of the deck, if American General could realistically prevail. As to the scorched earth aspect of the Repurchase Program, the issue was never raised. Although if it were raised, the court would have probably dismissed it, because the only important issue was the target board's actions as they affected a hypothetical proxy contest. The depletion of cash would not affect a proxy contest.

Although the court noted the importance of limiting the defensive response so that it is proportional to the threat, the court in fact minimized the importance of that link. The threat was simply that the shareholders erroneously might have tendered into the American General offer because they failed to fully appreciate the long-term prospects of Unitrin. This threat could be addressed more directly than by proposing a $500 million share buy-back that incidentally gave the shareholder-directors a veto over a merger with American General (if American General acquired more than fifteen percent). Indeed, as the lower court noted, the poison pill operated to address that threat; unless the board redeemed the pill, American General could not purchase the tendered shares. The proportionality test is thus similar to the threat test: if independent directors determine that a threat is present, that determination will be upheld; if those directors determine that a given defense is appropriate, that determination will be upheld unless it is draconian.

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the Court's view, the only effect of the Repurchase Program was to preclude American General from acquiring more than fifteen percent in a tender offer and then proposing a merger with Unitrin at a price that would be unacceptable to the Unitrin shareholder-directors. (This scenario assumes American General's success in a proxy contest for control, since a merger proposal would have to be approved by the board.) The court was skeptical that the shareholder-directors would vote against a merger that made economic sense.

104. *Id.* at 1388-89.

105. *Unitrin*, 651 A.2d at 1389-90.

106. The Repurchase Program contemplated open market purchases of up to ten million of Unitrin's outstanding shares of common stock. Inasmuch as American General's tender offer was at $50-3/8 per share, it is reasonable to assume that Unitrin might have to pay around that much, and possibly more.

C. Williams v. Geier—*Heightened Scrutiny is Cabined*

Although not arising in the context of a control contest, *Williams v. Geier*[107] also provides shape to *Unocal*. In *Williams*, the board of Cincinnati Milacron, Inc. (Milacron) recommended, and the shareholders approved, a charter amendment that had the effect of enhancing the control of the shareholders holding a majority block in the corporation. The charter amendment—sometimes referred to as a "tenure voting" provision—gave ten votes per share to shareholders on the record date, but only one vote per share to shareholders who acquired their shares thereafter, until they held the shares for three years.[108] The effect was to afford the holders of a majority block, which was a family group, the opportunity to sell some of their stock and leave their control unaffected. Plaintiff alleged that the purpose of the plan was to entrench the family group in control and that shareholders would feel coerced to vote in favor of the plan because unless two-thirds of the shares favored the plan, the company would be delisted from the New York Stock Exchange.[109] The Court of Chancery, applying *Unocal*, held that the board had reasonable grounds to believe that a threat to the company existed—a potential hostile takeover—and that its response—the recapitalization plan—was reasonable in relation to that threat.[110] The Delaware Supreme Court affirmed, but held that under these facts *Unocal* did not apply.[111]

By rejecting the applicability of *Unocal*, the court demonstrated a willingness to take a very formalistic view of *Unocal*. The court describes the history of the recapitalization plan as beginning with a "determination" by a Milacron Executive Vice President, who was also a member of the board, "that it would be in Milacron's best interests to develop a recapitalization plan."[112] This statement, appearing near the beginning of the opinion, gives a hint of things to come. It seems unlikely that this officer made an abstract determination that it was in the corporation's best interests to adopt a recapitalization plan; rather, as the remainder of the opinion makes clear, the family members on the board were interested in a plan to protect the company from a hostile takeover. As the family controlled a majority of the stock, a takeover was only a possibility if they disposed of a portion of their stock. A way to permit disposition and maintain control was through a dual class voting structure, which ultimately was adopted. Without making very many assumptions, it appears as though the Milacron board acted to protect the interests of the controlling family group. The court obscured the genesis of the plan and emphasized the process used to approve it.

The process, the court decided, removed the case from the heightened scrutiny required by *Unocal* because the board did not act unilaterally.[113] Rather, because the recapitalization took the form of an amendment to the articles of incorporation requiring shareholder approval, and because the shareholders approved the plan, special scrutiny is

107. 671 A.2d 1368 (Del. 1996).

108. *Id.* at 1372.

109. *Id.* at 1374. Furthermore, even if two-thirds approved, the company risked delisting unless the Exchange adopted certain amendments to its rules then pending.

110. *Id.* at 1375.

111. *Id.* at 1377.

112. *Williams*, 671 A.2d at 1371.

113. *Id.* at 1377.

not necessary. The court noted, but dismissed as irrelevant, the fact that the family group, which would benefit from the recapitalization, owned a majority of the outstanding shares and could approve the plan without the votes of the minority.[114] This seems to implicate the concern that animated *Unocal* in the first instance—board action that the shareholders would be powerless (except through litigation) to challenge. In *Williams*, the only difference is the presence of a *pro forma* shareholder approval.[115] Indeed, as the court noted, less than a majority of the minority shareholders voted to approve the transaction. Nevertheless, because the board was nominally independent and because there was shareholder approval, as the statute requires, the plaintiff's challenge must fail.

The skepticism of board action reflected in *Unocal* was absent in *Williams*, which clearly narrows the scope of *Unocal*. This narrower reading of *Unocal* was re-emphasized by the court in a decision a year later in *Brazen v. Bell Atlantic Corp.*,[116] where the court examined a $550 million termination fee in a merger agreement not as a device designed to ward off potential acquirers, but rather as a liquidated damage provision. As such, the validity of such a provision was analyzed under contract principles, not the heightened scrutiny of *Unocal* or even the business judgment rule.[117] It is worth noting that the *Williams* decision drew a strong dissent from two of the five justices, who were troubled by the entrenching aspects of the recapitalization plan and indicated that the directors' duty of loyalty was implicated by their actions.[118]

D. Quickturn Design Systems, Inc. v. Shapiro—*An Opportunity Lost*

In *Quickturn Design Systems, Inc. v. Shapiro*,[119] the Delaware Supreme Court considered a "delayed redemption provision," or poison pill, that the Quickturn board added to its shareholder rights plan in response to a hostile tender offer from Mentor.[120] The provision would have limited the ability of a newly-elected board, for six months after the board was elected, to redeem Quickturn's poison pill to facilitate a sale of the company to an "interested person."[121] As defined, Mentor would be included within the definition of an interested person. The board's rationale for adopting the delayed redemption provision was "to force any newly elected board to take sufficient time to become familiar with Quickturn and its value, and to provide shareholders the opportunity to consider alternatives, before selling Quickturn to any acquirer."[122]

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114. *Id.* at 1380 (stating that "the presence of controlling majority stockholder did not undermine the validity of the stockholder vote").

115. The court noted that the proxy statement soliciting shareholder approval for the plan informed the shareholders that approval was "virtually assured." *Id.* at 1371 n.6.

116. 695 A.2d 43 (Del. 1997).

117. *Id.* at 47. *Williams* and *Brazen* stand in contrast to the Court's decision in *Gilbert v. El Paso Co.*, 575 A.2d 1131 (Del. 1990), where the Court seemingly expanded *Unocal's* reach when it held that heightened scrutiny applied "to any decision to act or refrain from acting" in response to a hostile tender offer, even if that decision was to negotiate a merger agreement with the offeror. *Id.* at 1145.

118. *Williams*, 671 A.2d at 1385-89.

119. 721 A.2d 1281 (Del. 1998).

120. *Id.* at 1283.

121. *Id.* at 1287. An "interested person" is anyone who "proposed, nominated or financially supported the election of the new directors to the board," thereby eliminating Mentor as a potential acquirer. *Id.*

122. *Id.* at 1290 (quoting from the opinion of the Court of Chancery, *Mentor Graphics Corp. v. Quickturn Design Sys.*, 728 A.2d 25, 50 (Del. Ch. 1998)).

The Court of Chancery analyzed the provision under *Unocal*, concluding that while the board had identified a threat (that the Quickturn shareholders might tender into the Mentor offer in ignorance of Quickturn's true value), the delayed redemption provision was a disproportionate response to that threat.[123] Among other problems with the provision, the Court of Chancery found that the stated rationale made no sense because under the terms of the provision, the newly-elected board could immediately upon election decide to redeem the poison pill and sell the company to a bidder other than Mentor.[124] In addition, the director defendants could not persuade the court why six months was a reasonable period, especially since the bylaws included a provision that required a ninety-day delay following a call by the shareholders for a special meeting to replace the board.[125] The ninety-day advance notice provision was supported by the board on the theory that the shareholders needed that long a period of time to carefully consider the change of direction that a new board might bring.[126] The court reasoned that if the shareholders could make such a determination in ninety days, surely the new board could as well.[127] Indeed, the new board would be making that determination during the same ninety-day period.

Although it affirmed the Court of Chancery, the Delaware Supreme Court rejected the applicability of *Unocal* on the facts before it. Instead, the Delaware Supreme Court held that the delayed redemption provision unduly interfered with the power of a board of directors to manage the business and affairs of a Delaware corporation under section 141(a) of the Delaware corporate code.[128] The court reasoned that the provision "prevents a newly elected board of directors from completely discharging its fiduciary duties to protect fully the interests of Quickturn and its stockholders" because the board may not be able to redeem the poison pill when it was in the best interests of the shareholders that it do so.[129]

While the Delaware Supreme Court's interpretation of section 141(a) and its applicability to the facts of this case appear sound, it is noteworthy that the court avoided the fiduciary duty analysis of the Court of Chancery. By comparison, the court's most recent opinion in this area, *Paramount Communications Inc. v. QVC Network Inc.*,[130] did turn on an examination of fiduciary duties. In *Paramount*, the Delaware Supreme Court considered the validity of agreements between Paramount and Viacom that advantaged Viacom in its contest with QVC for control of Paramount. The court held that these agreements, which included a "no-shop" provision and a favorable stock option agreement, so limited Paramount's ability to accept a superior offer that the board violated its fiduciary duties to Paramount's shareholders.[131] The court, presumably, could have held that the agreements were invalid under section 141(a) of the Code because the

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123. *Mentor Graphics Corp.*, 728 A.2d at 50 (Del. Ch. 1998).

124. *Id.* at 50. The Court of Chancery also stated that the delayed redemption provision violated Delaware Corporation Law (8 Del. C. §141(a)) by robbing the newly elected board of its authority to manage the corporation and fulfill its fiduciary duty to the shareholders.

125. *Id.* at 51.

126. *Id.*

127. *Id.*

128. *Quickturn Design Sys.*, 721 A.2d at 1291-92.

129. *Id.* at 1292.

130. 637 A.2d 34 (Del. 1994).

131. *Id.* at 50.

board had no authority to enter into agreements that limited itself or a future board. In comparing this case with *Quickturn*, one important difference is that *Quickturn* involved only one bidder, while *Paramount* involved two competing bidders for control of Paramount. In such cases, the board's ability to favor one suitor over another is highly limited.[132] The court may be signaling that its review of board behavior, in the absence of multiple suitors, will be less exacting.[133] If so, an analysis under §141(a) was the only alternative to a finding of no breach of fiduciary duty. Indeed, in *Unocal* itself the court upheld a draconian defensive maneuver, while no case has upheld a defensive maneuver that assured victory for one contestant over another. The point is simply this: the enhanced scrutiny called for by *Unocal* is not that onerous a test for a board if it is an independent board, as was the case in *Quickturn*. It is fair to speculate that had the court reached the fiduciary duty question in *Quickturn*, it may well have reversed the Court of Chancery, holding that Quickturn's board was independent and exercised due care in adopting the delayed redemption provision. Similarly, the court may well have deferred to the judgment of the independent board on the proportionality test. Court of Chancery decisions, discussed in the next section, seem to suggest a more rigorous analysis, but perhaps not.

V. *UNOCAL* IN THE COURT OF CHANCERY

A. AC Acquisition Corp.v. Anderson, Clayton & Co.*—The Paradigm for Judicial Intervention*

AC Acquisition Corp. v. Anderson, Clayton & Co.[134] is often cited as an example of a case in which the directors' response was disproportional to the threat presented and therefore subject to injunction under *Unocal*. AC Acquisition made a tender offer for any and all of Anderson's shares at fifty-six dollars per share, with a commitment to a back-end merger at the same price, in cash.[135] Anderson's defense was a partial self-tender at sixty dollars per share that ran simultaneously with AC's offer.[136] As AC's offer was conditioned on Anderson's abandonment of its self-tender and the receipt of fifty-one percent of Anderson's stock, Anderson's shareholders felt pressured to tender into Anderson's offer. They could not, as Chancellor Allen explained, tender into AC's offer and risk being frozen out of Anderson's offer, should AC's offer fail.[137] Because the defense had the effect of coercing the shareholders to accept Anderson's self-tender offer and, therefore, precluding the success of the AC offer, the court examined the nature of the threat under *Unocal* to determine if such a response was reasonable.

On this issue, the court characterized *Unocal* as merely requiring that the defendant directors demonstrate that their actions had a corporate, as opposed to a personal, purpose. They satisfied this burden, the court held, as the self-tender offered the

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

133. Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: The Impact of* QVC *and Its Progeny*, 32 HOUS. L. REV. 945, 958 (1995). *See generally* Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: Bridging the* Unocal-Revlon *Gap*, 35 ARIZ. L. REV. 989, 1023 (1993).

134. 519 A.2d 103 (Del. Ch. 1986)

135. *Id.* at 104.

136. *Id.*

137. *Id.* at 114.

company's shareholders an alternative to the AC offer that they might prefer.[138] This analysis effectively ignores the threat test, focusing as it does solely on the response. If a corporate board takes any action, whether or not in the context of a change of control transaction, for a noncorporate purpose, the action is ipso facto a breach of their fiduciary duty. What *Unocal* holds is that a threat must be identified in order to determine if the defensive action is reasonable in relation to that threat. Chancellor Allen's opinion suggested that there was no threat, writing at one point that there was "no evidence" that AC's offer "threatens injury to shareholders or to the enterprise."[139] He could, presumably, have held that under these circumstances the Anderson board would be precluded from taking any action to defeat AC's offer. Chancellor Allen was probably correct, however, in minimizing the threat test, because a board should always be able to act in a way that it believes is in the best interests of the company and its shareholders. Even if AC's offer posed no threat, the Anderson board may have believed, in good faith, that shareholders might have preferred an alternative that offered them similar consideration and the opportunity to remain as shareholders. So the issue, then, was whether Anderson could structure this alternative in a way that precluded the acceptance of AC's offer. The court concluded that it could not, relying on *Unocal's* proportionality test.

Chancellor Allen reasoned that as a rational shareholder could not fail to accept Anderson's self-tender, Anderson really did not provide the shareholders with a "choice."[140] Even if the shareholders preferred the AC offer of fifty-six dollars per share for all of their shares, the Anderson offer effectively precluded them from accepting it. The self-tender thus failed to achieve its purpose. The Chancellor then concluded, rather perfunctorily, that the self-tender was not "reasonable in relation to any minimal threat posed to stockholders by [AC's] offer."[141]

While the court reached the right result, its reasoning seems strained. The court never identified any threat, much less a minimal one, so that measuring a response against this threat is somewhat artificial, at best. A close reading of the opinion, however, reveals two important factors that justify the outcome, aside from the *Unocal* analysis. First, the Anderson board seems to be one that was dominated by insiders of the company. Early in the opinion, in the course of restating the business judgment rule, the court noted that the favorable presumptions of the rule end when a "predominately interested board" acts in a matter in which its members have a financial interest that is adverse to the corporation.[142] While the court never concluded that the Anderson board was a "predominately interested" board, it did note that when the board first formulated its response to AC's overtures, eight of its fifteen directors were officers of the company or its subsidiaries;[143] when the board subsequently reaffirmed its commitment to a company alternative to an AC offer, seven of the fifteen directors were insiders, one having resigned at the suggestion of Anderson's CEO;[144] and when the Anderson board

138. *Id.* at 112.
139. *AC Acquisition*, 519 A.2d at 112.
140. *Id.* at 114.
141. *Id.*
142. *Id.* at 111.
143. *Id.* at 108, n. 4.
144. *AC Acquisition*, 519 A.2d at 109 & n. 7.

finally authorized the self-tender, seven of the fourteen directors were officers of the company or its subsidiaries.[145] Apparently, the court was somewhat skeptical of the motives of the Anderson directors, yet for some reason chose not to address the issue of board self-interest directly. Indeed, late in the opinion the court stated that it was not expressing any opinion on the question of the board's subjective intent.[146] The decision, however, could have been grounded on this factor: the board had a conflict of interest and, for that reason alone, bore the burden of demonstrating that their actions were entirely fair to the shareholders.

The real problem with the Anderson self-tender was that it precluded the success of the AC tender offer, which was itself a fair, noncoercive offer. Thus, the court could have held that when shareholders face a noncoercive offer, the target board is precluded from interfering with the shareholders' opportunity to accept that offer because the offeror has a legally protectible interest in its offer. So stated, this would be a radical departure from accepted Delaware law, which does not expressly recognize any such interest on the part of a bidder. Allen's opinion, however, implicitly recognizes this interest, at least to the extent the opinion does not rest on the board's conflict of interest. The more recent case of *Chesapeake Corp. v. Shore*,[147] discussed in the next section, can be similarly explained.

B. Chesapeake Corp. v. Shore—*A Hypothetical Appeal to the Delaware Supreme Court*

Chesapeake is a case worth considering because it implicates the key post-*Unocal* cases noted above, but may have drawn the wrong conclusion from those cases. The heart of the controversy in *Chesapeake* was a decision by the board of Shorewood Packaging Corporation to adopt a bylaw amendment that required a 66.67% vote (later reduced by the board to a 60% vote) of the shareholders to amend the bylaws.[148] Shorewood's bylaws provided for a staggered board and its board was concerned that Chesapeake, which was threatening a hostile tender offer for Shorewood at the time the board adopted this bylaw amendment, would seek to amend Shorewood's bylaws and remove the staggered board provision through a consent solicitation. Chesapeake challenged the board's action under *Unocal*.[149] The Court of Chancery upheld the challenge, reasoning that the bylaw was a disproportionate response to the threat posed by Chesapeake's offer, which was price inadequacy. Given the distribution of share ownership in Shorewood—inside directors held twenty-four percent of the outstanding stock and announced that they would vote against the Chesapeake solicitation—the effect of the bylaw amendment

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145. *Id.* at 110 n.8.

146. *Id.* at 114.

147. 771 A.2d 293 (Del. Ch. 2000). *See generally* Mark J. Loewenstein, Chesapeake v. Shore: *The Delaware Court Considers Defensive Bylaw Amendments*, 8 CORP. GOV. ADVISOR 9 (2000).

148. *Chesapeake*, 771 A.2d at 297.

149. *Id.* The board's action was also challenged under the *Blasius* "compelling justification" standard of review. *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988). Under the *Blasius* standard, a bylaw intended to inhibit the right of shareholders to vote is valid only if there is a compelling justification for that action. The court held that the mild threat posed by Chesapeake's all-shares all-cash tender offer "provides no legitimate justification at all." *Chesapeake*, 771 A.2d at 345. Note that *Blasius* is not discussed in this article. For a discussion of *Blasius*, see Schaer, *supra* note 6; Andrew C. Houston, Blasius *and the Democratic Paradigm in Corporate Law*, 17 DEL. J. CORP. L. 843 (1992).

was to make it virtually impossible for Chesapeake to succeed in its efforts to solicit enough votes to amend the Shorewood bylaws.[150] Given the mildness of the threat—mere price inadequacy—the Court of Chancery opined that less potent defenses, such as an aggressive communications plan urging shareholders to vote against the solicitation, should have been employed.

The *Chesapeake* decision raises two interesting questions in the *Unocal* context. First, does a potential acquirer have some sort of protectible interest in amending the bylaws of the target corporation? While the Court of Chancery drew heavily on the *Unitrin* case for guidance, ultimately deciding that *Unitrin* provided support for its conclusion that Shorewood's defense was disproportionate, the issue in *Unitrin* was somewhat different. The acquirer in *Unitrin*, American General, objected to a stock repurchase program that it alleged would have made a potential merger with Unitrin too difficult to achieve.[151] The Delaware Supreme Court rejected this claim, in part because American General failed to demonstrate that it could not succeed in a proxy *contest* for control of Unitrin.[152] Were one to apply the holding in *Unitrin* narrowly, one might conclude that a similar outcome awaits Chesapeake—nothing that the Shorewood board did limited Chesapeake's ability to prevail in a proxy contest for control of Shorewood. Chesapeake was only limited in its ability to remove a bylaw provision establishing a staggered board. There was no indication in the case, however, whether other avenues to achieve control of Shorewood were available to Chesapeake. For instance, Chesapeake might have proposed a bylaw amendment to increase the size of Shorewood's board and appoint its nominees as successors, or taken some other action to guarantee control.[153]

A more fundamental question, however, is one that the Court of Chancery expressly decided not to address: whether a board of directors has the authority under Delaware law to limit the ability of its shareholders to amend the bylaws.[154] One lesson that can be drawn from each of the Delaware Supreme Court's recent *Unocal* cases is that the court is slow to reach the fiduciary duty question, despite the language of *Unocal* itself. Drawing on *Quickturn*, for instance, it seems likely that the Delaware Supreme Court would prefer to consider whether the board acted beyond its authority in adopting the supermajority bylaw and would likely conclude that it had. The effect of the board's decision was to limit the ability of shareholders to act under section 109 of the Delaware Code, which empowers shareholders to amend the bylaws of the corporation. The board

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150. Chesapeake owned or controlled twenty percent of Shorewood. In order for Chesapeake to succeed in a proxy contest, they needed an additional forty percent of the shareholder votes. Of the eighty percent remaining, Shorewood owned or controlled twenty-four percent, leaving fifty-six percent of disinterested shareholding. That meant that Chesapeake actually had to obtain seventy-one percent of the shares not committed to Shorewood or Chesapeake to reach the sixty percent majority.

151. *Unitrin*, 651 A.2d at 1383.

152. *Id.*

153. *See* Moore Corp. Ltd. v. Wallace Computer Serv., Inc., 907 F. Supp. 1545 (D. Del. 1995), where the potential acquirer, Moore, faced a situation similar to that faced by Chesapeake and proposed to take control by reducing the size of the board.

154. Construing Illinois law, the federal court held that a director-adopted bylaw amendment, requiring that shareholders must approve any shareholder-adopted bylaw by a vote of two-thirds of all eligible votes, did not constitute a breach of fiduciary duty by the directors under the facts of that case. The plaintiffs did not, however, challenge the director action on the theory that the directors lacked the authority to adopt such a bylaw. Treco, Inc. v. Land of Lincoln Sav. & Loan, 749 F.2d 374 (7th Cir. 1984).

of directors has the authority to "adopt, amend or repeal" bylaws only if that power is conferred in the articles of incorporation and even then the code expressly protects the power of the stockholders: "The fact that such power [to adopt, amend or repeal] has been so conferred upon the directors . . . shall not divest the stockholders . . . of the power, nor limit their power to adopt, amend or repeal bylaws."[155] The implication of section 109(a) is that the power of the stockholders to amend bylaws is superior to that of the board. Section 109 can be seen as a parallel to section 141, which empowers the directors to manage the business and affairs of the corporation.[156] Just as a board of directors cannot limit the ability of future boards to exercise their authority under section 141, a board may not limit shareholder authority under section 109(a).

Surprisingly, the Delaware courts have not directly addressed the question of whether a board can limit the ability of shareholders to amend the bylaws, although some cases suggest that the shareholders' power is superior. For instance, in *American International Rent-A-Car, Inc. v. Cross*,[157] the board acted during an adjournment of the annual stockholders meeting to repeal a bylaw when it appeared that the shareholders would refuse to do so at the meeting.[158] A shareholder then sought, unsuccessfully, to enjoin the action of the board. The Court of Chancery, in the course of its opinion denying the injunction, noted that if the shareholders were dissatisfied with the board's action, they could reinstate the bylaw and deny the board the power to amend or repeal it.[159] This opinion thus suggests, albeit in dictum, that the stockholders can limit the authority of the board regarding amendment to the bylaws, but not vise versa. If this is true, then it seems to follow that the board's attempt to limit the stockholders' ability to amend the bylaws is ineffective. In *Datapoint Corp. v. Plaza Securities Co.*,[160] the Delaware Supreme Court enjoined the enforcement of a director-adopted bylaw that limited the ability of the shareholders to act by written consent. The court noted that under section 228 of the Delaware Code, action by written shareholder consent is effective when sufficient consents have been signed by the shareholders.[161] A bylaw that delays the effectiveness of such action (in this case for sixty days) unduly interferes with this right and is therefore unenforceable. By analogy, a director-adopted bylaw that interferes with the shareholders' statutory right to amend the bylaws ought to be unenforceable as well.[162]

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155. DEL. CODE ANN. tit. 8, §109(a) (2000).

156. DEL. CODE ANN. tit. 8, §141 (2000).

157. No. 7583, 1984 WL 8204 (Del. Ch. May 9, 1984)

158. *Id.* at *2.

159. *Id.* at *3. *But see* DAVID A. DREXLER et al., DELAWARE CORPORATION LAW AND PRACTICE § 9.02, at 9-4 (1996) ("[T]his somewhat casually offered suggestion cannot fairly be read as a definitive holding that such stockholder's action would be more binding than the directors' subsequent repeal of the repeal.").

160. 496 A.2d 1031 (Del. 1985).

161. DEL. CODE ANN. tit. 8, § 228 (2000).

162. In *Sec. & Exch. Comm'n v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947), the court held that under the federal proxy rules, a corporation could not omit from its proxy statement a shareholder proposed bylaw amendment that would remove a requirement that shareholders can only vote on bylaw amendments that have been included in the notice of the meeting. The board used this power to limit the ability of shareholders to amend the bylaws, which the court characterized as "untenable." *Id.* at 518. This decision also supports the supremacy of shareholder action, effectively nullify the existing bylaw that the board relied upon for omitting the shareholder's proposal. On the other hand, the opinion might be more narrowly construed as simply an interpretation of the proxy rules.

This Article does not mean to suggest that the Court of Chancery was wrong in *Chesapeake* when it found that the Shorewood board breached its fiduciary duties. Inside directors dominated Shorewood's board; the board's actions were suspect for that reason alone.[163] The case raises the prospect, however, that as a matter of fiduciary duties, even an independent board could not have taken the actions that were taken. One might wonder, in light of *Paramount* and *Unitrin*, whether the Delaware Supreme Court would be prepared to go so far. The court has never held that an independent board could not thwart a hostile takeover, at least as long as the acquirer could prevail in a proxy contest. Indeed, commentators on *Unocal* often overlook the fact that the Delaware court has made it clear that a board does not have a duty to negotiate with a third party for the sale of the company, at least so long as its decision is made in good faith and on an informed basis.[164] Clearly, Chesapeake could have prevailed in a proxy contest for Shorewood, even though control of the board would have taken two elections.

VI. CONCLUSION

The post-*Unocal* cases demonstrate a simple truth: Delaware courts will not interfere with the decisions of an independent board responding to a hostile tender offer. While a clearly higher degree of scrutiny is routine when a change of control is inevitable, those cases are a distinct subset of the takeover cases. The court's underlying rationale for its hands-off approach is that potential acquirers can achieve control through a proxy contest. This, in turn, requires an appeal to the target's stockholders, who presumably can decide whether they prefer the plans of the acquirer to those of the target management without the pressure of a pending offer for their shares. The Delaware courts have supported this preference for proxy fights over tender offers by issuing decisions that limit the ability of target boards to interfere with shareholder voting. In *Blasius Industries v. Atlas*,[165] the Court of Chancery, in an opinion later cited with approval by the Delaware Supreme Court,[166] held that when a board interferes with shareholder democracy, it must demonstrate a compelling justification for its actions.[167] In an earlier case, *Schnell v. Chris Craft Industries, Inc.*,[168] the Delaware Supreme Court held that a board could not act in an inequitable manner even if the action taken was consistent with

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> [T]he possibility that management might be displaced if a premium-producing tender offer is successful creates an inherent conflict between the interests of stockholders and management. There is always the possibility that subjectively well-intentioned, but nevertheless interested directors, will subconsciously be motivated by the profoundly negative effect a takeover could have on their personal bottom lines and careers.

Chesapeake, 771 A.2d at 328-29 (citation omitted).

164. *See, e.g.*, Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1152 (Del. 1990) ("We have repeatedly stated that the refusal [of directors] to entertain an offer may comport with the valid exercise of a board's business judgment."); Kahn v. MSB Bancorp, No. 14712-NC, 1998 WL 409355, at *3 (Del. Ch. July 16, 1998) (rejection of merger offer not subject to *Unocal* analysis but rather judged under business judgment rule).

165. 564 A.2d 651 (Del. Ch. 1988).

166. *See* Zirn v. VLI Corp., 681 A.2d 1050 (Del. 1996).

167. *Blasius*, 564 A.2d at 661.

168. 285 A.2d 437 (Del. 1971). *See generally* Douglas M. Branson, *The Chancellor's Foot in Delaware:* Schnell *and Its Progeny*, 14 J. CORP. L. 515 (1989) (exploring the contours of *Schnell*).

the corporation's bylaws.[169] In *Schnell*, the board moved the date of the corporation's annual meeting to thwart the efforts of the plaintiff, who was planning a proxy contest.[170] Thus, while the board may interfere with a shareholder's decision to sell his or her shares, it may not interfere with a shareholder's freedom to vote those shares.

This fundamental premise of Delaware law seems to be based on the notion that the legitimacy of director action derives from the vote of the shareholders.[171] So long as shareholders retain the freedom to elect or remove directors by voting, the fact that directors may interfere with the shareholders' ability to sell their shares is less troubling. While *Blasius* and *Schnell* are important safeguards for shareholders, it is important that shareholders retain other means to enhance their franchise. For instance, shareholders should be able to amend the bylaws of the corporation without interference from the board. The answer to the question in *Chesapeake*—whether a board can limit the ability of shareholders to amend the bylaws—should be obvious in light of the role that shareholder democracy plays in the scheme of Delaware law.[172] Similarly, the courts should be willing to suspend the applicability of an existing bylaw that interferes with shareholder voting[173] and closely examine board actions that appear to manipulate the outcome of shareholder votes.[174]

If, in fact, *Unocal* added nothing of substance to prior Delaware law and if directors of a target company are little constrained by Delaware law, then what of it? A few conclusions follow. First, the *Unocal* case has diverted the attention of the courts—and probably litigators as well—from developing a jurisprudence around the independent interests of a bidder, *qua* bidder. In other contexts, an economic actor who develops a prospective economic advantage is entitled to protection from unfair interference with that expectation, which one court has characterized as the "line of demarcation between permissible behavior and interference [that] reflects the ethical standards of the community."[175] This common law doctrine encourages persons to invest in potential opportunities and, in the context of the market for corporate control, benefits shareholders. Thus, failing to recognize the interests of potential bidders ultimately may overly deter investment in corporate acquisitions.

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169. *Schnell*, 285 A.2d at 439.

170. *Id.*

171. Stephen J. Massey, *Chancellor Allen's Jurisprudence and the Theory of Corporate Law*, 17 DEL. J. CORP. L. 683 (1992).

172. *See* Wisconsin Inv. Bd. v. Peerless Sys. Corp., No. CIV.A.17637, 2000 WL 1805376, at *7 (Del. Ch. Dec. 4, 2000) (stating that "in the context of takeover defenses, the Delaware courts have forcefully written that board actions that affect the rights of shareholders to vote are deeply suspect"). *See generally* Dale A. Oesterle & Alan R. Palmiter, *Judicial Schizophrenia in Shareholder Voting Cases*, 79 IOWA L. REV. 485 (1994) (discussing the critical role of the courts in protecting shareholder voting).

173. Hubbard v. Hollywood Park Realty Enter., Inc., No. CIV.A.11779, 1991 WL 3151 (Del. Ch. Jan. 14, 1991) (holding that the board must waive a bylaw that required ninety day advanced notice of nominees for director because within the ninety day period the board entered into an arrangement with a dissident group of shareholders that was not anticipated by another shareholder group; to preclude the plaintiffs from proposing a slate of nominees would be inequitable); Int'l Banknote Co., Inc. v. Muller, 713 F. Supp. 612 (S.D.N.Y. 1989) (similar); Lerman v. Diagnostic Date, Inc., 421 A.2d 906 (Del. Ch. 1980) (similar).

174. *Peerless Sys. Corp.*, 2000 WL 1805376, at *10-*12 (expressing skepticism at decision of corporate president to adjourn annual meeting because one of three company-sponsored proposals did not pass).

175. Panter v. Marshall Field & Co., 646 F.2d 271, 298 (7th Cir. 1981).

It may be fair to say that the Delaware courts are sensitive to this problem, at least implicitly. A level playing field for competing bidders is the result of the *Revlon* decision, although the decision is couched in terms of the duty of directors to shareholders. Guaranteeing a level playing field also explains the *AC Acquisitions* case and the more recent *ACE Ltd. v. Capital Re Corp.*[176] decision in the Court of Chancery. In the *ACE* decision, the Court of Chancery refused to enjoin the termination of a merger agreement, holding that the "no-shop" clause, which seemed to preclude the termination, was unenforceable.[177] The court reasoned that by agreeing to such a clause, the board breached its fiduciary duties to the corporation. Interestingly, the court did not characterize this breach as one of care, loyalty or good faith, probably because the "breach" did not seem to fit neatly within any of those categories.[178] What the clause did accomplish, however, was a limitation on the ability of other bidders to compete, and that apparently troubled the court. Like *Quickturn*, *Ace* might have been decided on a different basis: the board acted beyond its authority in limiting its freedom of action. Indeed, at one point in the decision, the court referred to *Quickturn* in that context.

Second, if directors have no real limitations in defending against a change of control via tender offer, and proxy fights become the means to effectuate a change of control, it becomes increasingly important to protect shareholder democracy. While the Delaware courts have embraced the importance of protecting shareholder democracy in a number of different settings, the primacy of shareholder democracy is not secure unless shareholders have readily available means to amend the corporate bylaws, and probably, the corporate charter. *Chesapeake* is a fine illustration of the importance of protecting the shareholders' right to amend the bylaws; otherwise, directors may pose structural obstacles to the ability of shareholders to exercise their franchise. Of equal importance, shareholders should be able to amend the bylaws using the mechanism provided by Rule 14a-8 of the Securities Exchange Act of 1934.[179] This Rule, which provides shareholder access to the company's proxy statement, is available if it is proper under state law for the shareholders to amend the bylaws.[180] This, in turn, raises a question as to the nature of the bylaw amendment: What limitations, if any, are there on shareholder-initiated bylaw amendments? While it is beyond the scope of the Article to resolve the question, suffice it to say that bylaw amendments that protect shareholder voting rights or otherwise deal with fundamental issues of corporate governance would appear to be unassailable, while those touching upon the board's authority to manage the business of the corporation may be of questionable validity.[181]

As to charter amendments, however, the law is clear that shareholders lack the ability to amend the charter unilaterally and a statutory amendment would be necessary to

176. 747 A.2d 95 (Del. Ch. 1999).

177. *Id.* at 105.

178. *Id.* at 109.

179. 17 C.F.R. 240.14a-8.

180. *Id.*

181. *See generally* John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605 (1977) (discussing practical and theoretical implications of shareholders' initiatives).

grant that right.[182] The factual context of cases such as *Williams v. Geier*, discussed in Part IV above, suggest the wisdom of such a grant. Recall in *Williams* the majority shareholders engineered a charter amendment providing for tenure voting that assured their continued control of the corporation. The only way the shareholders could reverse this state of affairs would be through a repealing amendment, which is impossible unless the shareholders are able to initiate the process. In this context—where the proposed charter amendment relates to a fundamental issue of corporate governance—it seems reasonable to allow shareholders to initiate the process.

By giving shareholders the power to change the conditions under which the board operates, increased deference to board decisions becomes more palatable. Not only would shareholders retain the right to remove directors, but they could also limit their ability to adopt poison pills and other antitakeover devices. This somewhat radical suggestion is a logical extension of the concept of shareholder democracy. If shareholders had an ability to amend a corporate charter, the struggle in cases such as *Chesapeake* would be altered. The shareholders could not be thwarted by a director-adopted bylaw if they could amend the charter and nullify the bylaw.

Shareholder power to amend the charter raises fundamental issues of corporate governance and contract law. To some extent, the charter represents a contract between the directors and the shareholders, allocating power between them. To give the shareholders the unilateral power to amend the charter suggests that shareholders can alter this contract without the approval of the directors, violating accepted notions of contract law, not to mention those of corporate governance. But why does the amendment process depend on director involvement? Directors of a Delaware corporation are, after all, subject to removal by the shareholders with or without cause, subject to two exceptions.[183] The board's contractual expectations are somewhat limited. What is lost is the independent review of the directors, who have fiduciary duties to the corporation. A majority of shareholders generally have the right, however, to elect all of the directors (except where there is cumulative voting or some other arrangement such as dual class voting), so the independent review of the directors is of questionable efficacy, especially since ratification by the shareholders removes claims against the directors for breach of fiduciary duty of care.[184] Disabling shareholders from unilaterally amending the charter reflects a sort of paternalism that seems to have little place in a jurisprudence that values shareholder democracy as does Delaware's. This remedy for shareholders would dovetail nicely with *Unocal*. When operating the corporation and responding to threats to the corporation, directors are entitled to deference, but when the fundamental principles are

182. DEL CODE ANN. tit. 8, § 242(b)(1), (c) (1998). To amend the corporate charter, the board of directors must first adopt a resolution stating the proposed amendment. Shareholders then vote on the proposed amendment at either a special meeting or at the next annual shareholder's meeting. In addition, the resolution authorizing a proposed amendment may provide that the board may abandon the proposed amendment without further action by the shareholders if abandoned prior to filing the amendment with the Secretary of State. *Id.*

183. DEL CODE ANN. tit. 8, §141(k) (1998). Under this section, if the board is classified, directors can only be removed for cause and if there is cumulative voting no director may be removed without cause if the number of votes cast against his removal would be enough to have elected him. *Id.*

184. *In re* Wheelabrator Techs., Inc. S'holders Litig., 663 A.2d 1194 (Del. Ch. 1995) (extinguishing a claim by shareholders of target company, Wheelabrator, against directors for breach of fiduciary duty of care for recommending merger with Waste Management, Inc. because the shareholders approved of the merger by an informed vote.)

at stake, whether choosing directors or specifying the terms under which the directors operate (in the bylaws or charter), shareholders are supreme.