



January 1986

Auctioning the Corporate Bastion: Delaware Readjusts the Business Judgment Rule in *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*

David S. White

Recommended Citation

David S. White, Note, *Auctioning the Corporate Bastion: Delaware Readjusts the Business Judgment Rule in Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*, 40 Sw L.J. 1117 (1986)
<https://scholar.smu.edu/smulr/vol40/iss4/7>

This Case Note is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

AUCTIONING THE CORPORATE BASTION:
DELAWARE READJUSTS THE BUSINESS
JUDGMENT RULE IN *REVLON, INC.*
V. MACANDREWS & FORBES
HOLDINGS, INC.

IN June 1985 the corporate heads of Pantry Pride, Inc. and Revlon, Inc. privately met to discuss Pantry Pride's friendly acquisition of Revlon.¹ The talks broke down, and in August Pantry Pride launched a hostile tender offer for Revlon's shares with the intention of financing the acquisition through later sale of the company.² Revlon temporarily averted the threat by resorting to a number of defensive tactics that once again prompted Delaware courts to decide how far to protect directors' business decisions made in response to takeover threats.

Revlon's board of directors met on August 19 to evaluate Pantry Pride's tender offer and decide upon a response. An investment banker advised the board that Pantry Pride's \$45 a share offer was far too low a price for the company's stock. The banker believed Pantry Pride would finance its acquisition with junk bonds³ followed by a bust-up⁴ sale of Revlon that could yield up to \$60 to \$70 a share. Moreover, an outright sale of Revlon, according to the banker, should have brought a price in the mid-\$50 range.

The company's special counsel next advised the directors to adopt a two-fold defensive strategy. First, he urged that Revlon repurchase about one-sixth of its more than thirty-three million outstanding shares.⁵ Second, the counsel recommended a note purchase rights plan, a poison pill,⁶ which

1. MacAndrews & Forbes Holdings, Inc. is the controlling stockholder of Pantry Pride and the court referred to the plaintiff throughout its opinion as Pantry Pride.

2. A hostile tender offer is an unsolicited offer by an acquiring party to buy some or all of a target corporation's stock. See Sommer, *Hostile Tender Offers: Time for a Review of the Fundamentals*, in TENDER OFFERS 251 (M. Steinberg ed. 1985).

3. Junk bonds are typically low-rated bonds or preferred stock sold to finance a takeover. Buyers are attracted to junk bonds because the bonds have a high yield. See Daitz, *Leveraged Buy-Outs*, in ACQUISITIONS AND MERGERS: TACTICS, TECHNIQUES, AND RECENT DEVELOPMENTS, 1985, at 155 (M. Katz & R. Loeb eds. 1985).

4. A bust-up sale commonly follows a leveraged buyout or other forms of acquisition financed by junk bonds. Having financed the purchase of a target company with debt, the seller then sells certain divisions of the corporation to retire the debt. See Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities—An Update*, 40 BUS. LAW. 1403, 1412 (1985).

5. Revlon accomplished this repurchase with an exchange of notes for stock.

6. Poison pills come in several varieties, but a theme common to all is a distribution to the target's shareholders of securities specially designed to make acquisition impossible or unattractive. Most pills grant the holder the option of either selling its common shares at a

would provide each Revlon shareholder one note purchase right per share. The note purchase right would allow the holder to trade a common share of stock for a \$65 note if any one stockholder acquired 20% or more of the company's outstanding shares. The board could revoke the plan by redeeming the rights at ten cents each any time before the triggering acquisition. The acquiror could not participate in the plan. Revlon's board adopted both proposals.

On August 23 Pantry Pride initiated a cash tender offer at \$47.50 per share subject to financing and Revlon's redeeming the note purchase rights. Revlon countered on August 29 with a plan for exchanging up to ten million of its shares for subordinated notes at \$47.50 principal backed by covenants that limited Revlon's ability to acquire additional debt without approval by the independent members of the board.⁷ These notes proved an immediate success. The shareholders tendered 87% of the outstanding shares in exchange for notes, and the company accepted the full ten million shares on a pro rata basis.

Thus, Revlon seemingly blocked the takeover attempt as Pantry Pride tried unsuccessfully during September to force redemption of the note purchase rights. Determined nevertheless, at the end of September Pantry Pride raised its offer to \$50 a share. Other offers by Pantry Pride of \$53 and \$56.25 followed in quick succession. Earlier in September, however, Revlon's directors had authorized management to find and negotiate with other parties interested in acquiring Revlon. On October 3 the Revlon directors met to consider offers and agreed to a leveraged buyout⁸ by Forstmann Little

prescribed premium, the "put" pill, or purchasing common stock at a fixed discount, the "call" pill. In all cases, the option may be exercised only upon some triggering event, usually the acquisition of a certain amount of stock by the takeover bidder. See Lipton & Brownstein, *supra* note 4, at 1425-26. The pill makes acquisition more uncertain by availing put or call benefits to shareholders other than the acquiror. Fleischer & Golden, *Poison Pill*, Nat'l L.J., Feb. 24, 1986, at 28, col. 2. Typically, the special securities take the form of preferred stock or stock warrants. The preferred stock plans generally have a conversion feature by which the holder may exchange the preferred shares for acquiror's shares at a 50% discount if the takeover is successful. *Id.* at 26, col. 1; see also Chittur, *Wall Street Teddy Bear: The "Poison Pill" as a Takeover Defense*, 11 J. CORP. L. 25, 28 (1985) (discussing first preferred share pill issued by Lennox, Inc.).

Revlon adopted a stock warranty plan with a put option. The pill gave stockholders the right to exchange their shares for \$65 worth of notes per share. With this type of plan the board was actually announcing the price at which it would sell the company. See Fleischer & Golden, *supra*, at 24, col. 3. See generally Herzog & Katz, *Takeovers: Poison Pill Warrants*, Nat'l L.J., Mar. 25, 1985, at 15, col. 3; Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The Poison Pill Preferred*, 97 HARV. L. REV. 1964 (1984).

7. The exchange of notes for stock is a method of acquiring one's own stock without making a self-tender offer for cash. For a definition and discussion of self-tender offers see *infra* note 60. The purpose of Revlon's note plan was not only to accumulate shares but also to encumber the company with severe restrictions on its ability to incur additional debt, sell assets, or declare dividends. Since Pantry Pride intended to break up the company and sell off parts, covenants forbidding such sale made takeover by Pantry Pride very unattractive. Lesser, *Directors*, Nat'l L.J., Feb. 24, 1986, at 20, col. 1. Revlon priced the notes to match Pantry Pride's then current bid of \$47.50. The notes traded like bonds in denominations of \$1,000 and were subject to market fluctuations.

8. A leveraged buyout is a purchase financed largely through debt. See Daitz, *supra* note 3, at 149-50.

& Co., which offered \$56 a share for Revlon. Forstmann also agreed to assume Revlon's \$475 million debt incurred by the notes plan. Revlon agreed to redeem the note purchase rights and waive the covenants on the notes either for Forstmann or for anyone making a better offer.

When news of this arrangement reached the public, the market value of the notes, no longer buoyed by the covenants barring further debt, began to drop. Angry noteholders threatened legal action. At this point Pantry Pride raised its bid to \$56.25. Four days later the Forstmann group offered \$57.25 per share and agreed to support the notes upon Revlon's granting certain conditions: (1) a lock-up option⁹ to purchase two choice Revlon divisions at \$100-\$175 million below value; (2) a no-shop provision;¹⁰ (3) redemption of the rights and waiver of the notes covenants; and (4) a \$25 million cancellation fee to be placed in escrow and released to Forstmann if the agreement fell through or another acquiror received 19.9% or more of Revlon's common shares. Revlon's board approved the Forstmann offer, citing as one of its reasons the protection given to the noteholders.

Pantry Pride, having filed for injunctive relief against the note purchase rights plan in August, amended its pleading to challenge the lock-up option, the cancellation fee, and the notes and note purchase rights plans.¹¹ Pantry Pride raised its bid to \$58 per share on October 22, one day before the court of chancery granted the injunctive relief, holding that Revlon's directors had breached their duty of loyalty to the stockholders by approving the Forstmann offer out of apprehension over legal action threatened by the angry noteholders rather than out of concern for the stockholders' benefit.¹² Within a week the Delaware Supreme Court accepted Revlon's appeal and heard arguments. On November 1 the high court announced its decision in favor of Pantry Pride. *Held, affirmed*: When the sale of Revlon became

9. A lock-up option is an arrangement in which the target company in a takeover battle gives a third party some inducement to enter the bidding, usually the option to purchase part of the target's stock at a premium or to purchase certain coveted divisions of the corporation. Note, *Lock-Up Options: Toward a State Standard*, 96 HARV. L. REV. 1068, 1068 (1983) [hereinafter Note, *Lock-Up Options*]. The third party is referred to as a white knight. See Comment, *Anti-takeover Maneuvers: Developments in Defense Tactics and Target Actions for Injunctive Relief*, 35 SW. L.J. 617, 629 (1981); see also *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 273-74 (2d Cir. 1986) (although not illegal, lock-ups must not preclude bidding); *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757, 760-61 (2d Cir.) (court upheld sale of treasury stock to white knight, which thereby derived a significant advantage in takeover battle), *cert. denied*, 464 U.S. 1018 (1983); Kramer, *The Formulated Lock-Up: New Technique Emerges in Takeover Arena*, Nat'l L.J., Aug. 3, 1981, at 19, col. 1; Nathan, *Lock-Ups and Leg-Ups: The Search for Security in the Acquisitions Marketplace*, 13 INST. ON SEC. REG. 1, 4 (1982); Note, *"Lock-Up" Enjoined Under Section 14(e) of Securities Exchange Act—Mobil Corp. v. Marathon Oil Co.*, 699 F.2d 366 (6th Cir. 1981), 12 SETON HALL L. REV. 881, 892 (1982).

10. Similar to the lock-up, the no-shop agreement gives the white knight the advantage of exclusive dealing with the target. See *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1251 (Del. Ch. 1985) (chancery views no-shop provision as being cut from same cloth as lock-up), *aff'd*, 506 A.2d 173 (Del. 1986).

11. As a deterrent the cancellation fee was no different from certain features of the poison pill and the notes plan, yet Pantry Pride's haste in seeking a temporary restraining order was directed more at Revlon's placing the cancellation fee in escrow than at the other defenses. 501 A.2d at 1241.

12. *Id.* at 1250.

inevitable, the directors had a fiduciary duty to obtain the highest price for the stockholders. Revlon's directors breached their fiduciary duty of care by granting Forstmann a lock-up option and cancellation fee. The directors breached their duty of loyalty by protecting corporate constituencies other than shareholders out of concern for their own personal liability. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

I. FIDUCIARY DUTY AND THE BUSINESS JUDGMENT RULE

A. Background

One commentator referred to the development of the business judgment rule as applied by Delaware courts in corporate control contests as "the best law game in town."¹³ The business judgment rule is a simple idea, but one that eludes simple definition.¹⁴ The rule protects directors from any liability for harm resulting from their decisions as long as they meet certain standards of conduct.¹⁵ The rule has a long history of controversy.¹⁶ Under Delaware law the business judgment rule derives from corporate directors'

13. Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 1 (1985).

14. The business judgment rule has been defined as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); see *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985). Attempts at a precise formulation of the business judgment rule acceptable to all have generally met with frustration. See Manning, *The Business Judgment Rule and the Directors' Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1478 (1984). Manning argues that this frustration is due to the futility of using a prudent man standard to judge the activities of corporate directors when in fact no agreed standard exists for prudent directing. *Id.* at 1493; see *Arsht, The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 111 n.83 (1979) (discussing various definitions of the business judgment rule); see also *Fischel, The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1439 nn.3, 4 (1985) (listing recent formulations of the rule).

15. See, e.g., MODEL BUSINESS CORP. ACT § 8.30(d) (1984) (director not liable for any action if he performed duties of office in compliance with this section).

16. Important Delaware cases developing director's fiduciary duties and the business judgment rule prior to 1984 include *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 781-82 (Del. 1981); *Singer v. Magnavox Co.*, 380 A.2d 969, 975 (Del. 1977); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); *Lynch v. Vickers Energy Corp.*, 351 A.2d 570 (Del. Ch. 1976), *rev'd*, 383 A.2d 278, 281 (Del. 1977), *on remand*, 402 A.2d 5 (Del. Ch. 1979), *rev'd*, 429 A.2d 497 (Del. 1981); *Gimbel v. Signal Cos.*, 316 A.2d 599, 609 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974); *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503, 510 (Del. 1939).

Between 1980 and 1984, a series of federal court decisions interpreted the business judgment rule including *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984); *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984); *Buffalo Forge Co. v. Ogdan Corp.*, 717 F.2d 757 (2d Cir.), *cert. denied*, 464 U.S. 1018 (1983); *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981); *Panter v. Marshall Fields & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Treadway Cos. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980); *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690 (2d Cir. 1980); *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623 (D. Md. 1982). See *Greene & Palmiter, Tightened for Takeovers*, *Legal Times*, Jan. 20, 1985, at S3, col. 3 (special section) for discussion of the federal cases cited. For a series of articles devoted to the business judgment rule presented at the Institute on Dynamics of Corporate Control, see 39 BUS. LAW. 1461-1559 (1984) and 40 BUS. LAW. 1373-1455 (1985).

statutory responsibility for making ultimate corporate decisions.¹⁷ This responsibility brings with it, however, a fiduciary duty to the corporation and its shareholders.¹⁸

The concept of fiduciary duty is twofold. Directors must handle corporate business with the same degree of care as any other reasonably prudent person under similar circumstances.¹⁹ For directors choosing defenses against attempted takeovers, this duty of care usually means seeking adequate information by the best means reasonably available before making a decision.²⁰ Directors also owe a duty of loyalty to the stockholders to make decisions in good faith and in the best interests of the corporation.²¹ Courts are aware that directors in a control contest are invariably torn between their duty of loyalty and their sense of self-preservation.²²

The business judgment rule is in fact a presumption by the courts that directors are in a better position than judges to make business decisions.²³ This deference to professional judgment is no different from that accorded surgeons or other professionals.²⁴ An operation may appear disastrous in hindsight, but judges do not infer a doctor's or director's breach of duty from a bad result.²⁵ Furthermore, a judge will not attach liability unless the plaintiff first comes forward with enough evidence to cast doubt upon the defendant's motive or vigilance.²⁶

B. Aronson v. Lewis

In the late 1970s critics assailed the business judgment rule in Delaware and elsewhere as creating an impenetrable shield around directors' decisions.²⁷ The controversy dealt with the rights of minority stockholders to

17. *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984). The court in *Pogostin* traced the authority for the business judgment rule to the statute providing that a corporation's directors have discretion over the affairs of a corporation. DEL. CODE ANN. tit. 8, § 141(a) (1985).

18. See *Loft, Inc. v. Guth*, 23 Del. Ch. 138, 2 A.2d 225, 229, *aff'd*, 23 Del. Ch. 255, 5 A.2d 503 (Del. 1939). One commentator has charged that the term fiduciary is misleading and is an analogy at best. Manning, *supra* note 14, at 1493. The manager of an entrepreneurial enterprise should not be held to the standard of a trustee who must be a prudent investor. *Id.* *But cf.* Comment, *Director Liability Under the Business Judgment Rule: Fact or Fiction?*, 35 Sw. L.J. 775, 781 n.56 (1981) (citing case law that director is trustee).

19. See *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 264 (2d Cir. 1984); see also W. KNEPPER, *LIABILITY OF CORPORATE OFFICERS AND DIRECTORS* § 1.03 (3d ed. 1978) (directors also have duty to conduct business in obedience to corporate charter and rules).

20. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

21. See *Arsht*, *supra* note 14, at 115-16 (discussing duty of loyalty and director interest); see also *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503, 510 (Del. 1939) (directors owe fiduciary duty of care and loyalty to corporation).

22. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

23. See *Fischel*, *supra* note 14, at 1443.

24. See *Arsht*, *supra* note 14, at 97 (business judgment should give directors same protection afforded other professionals when sued for malpractice); see also *Casey v. Woodruff*, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944) (court found no conflict between business judgment rule and concept of negligence).

25. See *Arsht*, *supra* note 14, at 97.

26. *Pogostin v. Rice*, 480 A.2d 619, 624-25 (Del. 1984); see also *Veasey*, *Business Judgment Rule: The New Incarnation*, *Legal Times*, Mar. 10, 1986, at 25, col. 2 (plaintiff has burden of coming forward and ultimate persuasion).

27. The attack centered in Delaware after William Cary, former Chairman of the Securi-

force an accounting of the directors' actions.²⁸ In this context the Delaware Supreme Court in *Aronson v. Lewis*²⁹ redefined the business judgment rule.³⁰

In *Aronson* the issue concerned whether the plaintiff alleged breach of loyalty with enough particularity to overcome the rule's presumption in favor of the directors.³¹ The court of chancery agreed with the plaintiff that certain consulting fees and other arrangements with a major stockholder appeared to have no business purpose.³² The lower court found that the plaintiff had alleged sufficient facts to permit the inference that the business judgment rule did not apply.³³

The state supreme court reversed and explained that directors should be accorded the presumption of having made informed good faith decisions as an acknowledgement of their managerial prerogatives.³⁴ Courts may not infer a breach of duty from the consequences of directors' decisions.³⁵ Allegations, however, that directly attack directors' disinterestedness or carefulness may serve to rebut the presumption.³⁶ If, for example, a plaintiff alleges that a director has dealt on both sides of a transaction or stands to derive from an act personal gain not generally available to all stockholders, a court may step in and require the director to justify the act.³⁷ The burden of proof then shifts to the director. A court may likewise intervene if evidence shows that a board did not decide an issue based upon all important information reasonably available to it or that the board acted without sufficient care.³⁸

The Delaware Supreme Court in *Pogostin v. Rice*³⁹ applied the *Aronson* principles in 1984 to a shareholders' derivative suit instituted to force a cor-

ties and Exchange Commission, argued that Delaware's permissive statutes and case law allowed corporations to profit at the expense of the shareholders. Cary characterized Delaware's prominent position in corporation law as the result of that state's winning a "race for the bottom." Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974). For a list of references echoing Cary's thesis see Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913, 913 n.1 (1982). The role of the business judgment rule provided the centerpiece for the debate. The view at that time, as Delaware applied the rule, was that courts would not intervene unless they found evidence of "gross and palpable overreaching" by the directors. This approach effectively placed director misconduct beyond judicial reach. See Arsht, *supra* note 14, at 93-94. The goal of these critics was to bring about reforms through federal chartering of corporations. See generally R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* 180 (1976).

28. See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981); *Singer v. Magnavox Co.*, 380 A.2d 969, 972 (Del. 1977); *Lynch v. Vickers Energy Corp.*, 351 A.2d 570, 573 (Del. Ch. 1976), *rev'd*, 383 A.2d 278 (Del. 1977), *on remand*, 402 A.2d 5 (Del. Ch. 1979), *rev'd*, 429 A.2d 497 (Del. 1981); see also *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984) (derivative action balances shareholder interest against managerial power of directors).

29. 473 A.2d 805 (Del. 1984).

30. *Id.* at 812.

31. *Id.* at 808.

32. *Id.*

33. *Id.* at 809.

34. *Id.* at 812.

35. See *id.*

36. *Id.*

37. *Id.*; see also Arsht, *supra* note 14, at 127-28 (most prevalent forms of bad faith are directors' improper attempts to preserve themselves in office).

38. 473 A.2d at 812.

39. 480 A.2d 619 (Del. 1984).

poration to accept a hostile tender offer. In *Pogostin* the court tested plaintiffs' allegations of directors' self-interest under the two-part analysis described in *Aronson*.⁴⁰ Finding that the allegations, if taken as true, were not sufficient to cast doubt on the directors' interests in the decision or on their diligence in reaching the decision, the high court held that the board was protected by the business judgment rule.⁴¹ The court also made the point that the reasoning followed in *Aronson* applied in a takeover context.⁴²

At this juncture the business judgment rule seemed well entrenched.⁴³ As hostile takeover techniques became more and more sophisticated, however, boards improvised unusual and controversial new defensive tactics.⁴⁴ How far Delaware courts would go in protecting directors' actions in response to a takeover attempt remained unclear.⁴⁵

C. *Smith v. Van Gorkom*

In *Smith v. Van Gorkom*⁴⁶ the Delaware Supreme Court held that directors of Trans Union Corporation did not reach an informed business decision in approving a cashout merger⁴⁷ negotiated by the company's chief executive officer; the directors thereby breached their duty of care to the stockholders.⁴⁸ The decision received almost universal criticism primarily because the offer represented a 50% premium over market price and because the Trans Union board seemed eminently qualified to make the decision.⁴⁹ Commentators argued that the result hardly seemed to justify a finding of gross negligence by the court.⁵⁰ The court chose not to look at the result, however, but at the way the board considered the proposal.⁵¹

40. *Id.* at 624; see *Aronson*, 473 A.2d at 812.

41. 480 A.2d at 627.

42. *Id.*

43. See *Arsht*, *supra* note 14, at 93-94.

44. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957 (Del. 1985) (corporate law is not static but must address problems created by exotic takeover and defensive tactics).

45. See *Prentice*, *Target Board Abuse of Defensive Tactics: Can Federal Law be Mobilized to Overcome the Business Judgment Rule?*, 8 J. CORP. L. 337, 346 (1983).

46. 488 A.2d 858, 873 (Del. 1985).

47. In a cashout merger, the shareholders of one of the two merging corporations receive cash for their shares. See *Weiss*, *Balancing the Interests in Cash-Out Mergers: The Promise of Weinberger v. UOP, Inc.*, 8 DEL. J. CORP. L. 1, 2 n.4 (1983).

48. The list of information necessary for an informed decision should include fairness opinions issued by investment bankers, relevant studies and evaluations disseminated to the board before board meetings, consultation with key management and in-house counsel, review of various methods for evaluating stock price and comparative outcomes, detailed reports at board meetings presented so as to prompt questions from directors, and time for reading and discussing relevant documents. Manning, *supra* note 13, at 1.

49. Koch, *Business Judgment Now Burdens Directors: Smith v. Van Gorkom*, 8 Nat'l L.J., Oct. 28, 1985, at 15, col. 3; Herzel, *Smith Brings Whips Down on Directors' Backs*, Legal Times, May 13, 1985, at 14; Borden, *First Thoughts on Decision in Delaware on Trans Union*, N.Y.L.J., Feb. 25, 1985, at 1, col. 3; see also Manning, *supra* note 13, at 1 (reaction of corporate bar reported as atrocious).

50. Manning, *supra* note 13, at 5.

51. 488 A.2d at 874. The court's method of analysis is consistent with that prescribed in *Aronson*, 473 A.2d at 808. Once a plaintiff has brought forth enough evidence to impugn the care with which the board made its decision, the defendants have the burden of justifying their actions. *Van Gorkom*, 488 A.2d at 875.

The directors of Trans Union were unaware of the proposed transaction, by which management would acquire Trans Union in a cashout merger, until the chief executive officer of the company called a special meeting to present the proposal. No investment banker was present. No valuation reports or even the text of the proposed agreement were available for review, nor did the directors request such information. The board approved the plan after a two-hour meeting solely on the basis of a twenty-minute oral presentation and the statements of two other executives. The court found that the board's inquiry and deliberation were insufficient as a matter of law and that the board was grossly negligent in approving the action with such inadequate investigation.⁵²

The *Van Gorkom* decision seems to require directors to master a list of rules for conducting a board meeting.⁵³ Boards after *Van Gorkom* must create at least the appearance of making a thorough and painstaking inquiry before passing judgment on a proposed transaction.⁵⁴ As the dissent in *Van Gorkom* pointed out, however, the overview of the entire process, not the isolated details, is important.⁵⁵ Some have pointed out that directors should have the flexibility to allocate their time as they see fit.⁵⁶ Requiring the same paper trail and exhaustive inquiry for each decision takes a terrible toll on directors' time.⁵⁷

Another view of *Van Gorkom* argues that the Delaware Supreme Court chose that case as a vehicle to respond to a growing backlash against what some perceived as an inordinate amount of discretion allowed directors.⁵⁸ Even if the accusations were true, the court took little time in reaffirming the efficacy of the rule by upholding a board's defensive actions against a noted greenmailer in *Unocal Corp. v. Mesa Petroleum Co.*⁵⁹

D. Unocal Corp. v. Mesa Petroleum Co.

Less than four months after issuing its decision in *Van Gorkom*, the Delaware Supreme Court upheld Unocal Corporation's selective self-tender offer made in response to Mesa Petroleum Company's hostile two-tier, front-end loaded cash tender offer.⁶⁰ Unocal's board followed well-approved proce-

52. 488 A.2d at 873.

53. Committee on Corp. Laws, Section of Corp., Banking and Bus. Law, American Bar Ass'n, *Guidelines for Directors: Planning for and Responding to Unsolicited Tender Offers*, 41 BUS. LAW. 209, 214 (1985); Manning, *supra* note 13, at 3.

54. See Manning, *supra* note 13, at 3.

55. 488 A.2d at 897.

56. See Manning, *supra* note 14, at 1487-88.

57. *Id.*

58. See Greene & Palmiter, *supra* note 16, at S10, col. 1. The *Van Gorkom* dissent perhaps implied that the majority was using the case in such a manner by stating that "[t]he majority opinion reads like an advocate's closing address to a hostile jury." 488 A.2d at 893.

59. 493 A.2d 946, 956 (Del. 1985). A greenmailer is one who accumulates stock not for the purpose of acquiring the target, but to sell the holdings at a premium. See Lipton & Brownstein, *supra* note 4, at 1413.

60. 493 A.2d at 958. A two-tier, front-end loaded tender offer is a two-step process designed to obtain 100% control of a company. In the first step, the acquiror makes an attractive tender offer for a determined percentage of the outstanding shares large enough to gain

dures in studying the threat and took its action for a proper corporate purpose.⁶¹ At the time of its tender offer, Mesa had acquired 13% of Unocal's shares and announced its intention to acquire 37% of the shares for a price Unocal determined as wholly inadequate. Mesa, being a known greenmailer, however, presented the potential danger of a stampede effect caused by shareholders afraid of being left out of the first step of Mesa's acquisition.⁶²

Unocal's board fashioned a response that in effect offered stockholders junk bonds at a much higher value than the bonds Mesa offered. The controversy centered around Unocal's decision to exclude Mesa from this self-tender offer. To include Mesa in the tender would defeat the goal of adequately compensating shareholders at the back-end of Mesa's proposal because every Mesa share accepted would displace one held by another stockholder.⁶³ Also, the target effectively would have financed the acquiror's own inadequate proposal if Mesa were permitted to tender to Unocal.⁶⁴

In approving the directors' decision the court focused on the specific procedures the board followed and the purpose behind the decision.⁶⁵ The board met on two separate occasions. The first meeting lasted nine and one-half hours. Legal counsel offered a detailed presentation concerning the board's obligations under state and federal law, and investment bankers explained the valuation techniques they used to reach the conclusion that Mesa's price was inadequate. In addition, the directors received information about Unocal's ability to undertake a selective self-tender. Also, the eight outside directors met separately with Unocal's attorneys and financial advisors. The board meeting concluded with a resolution to reject Mesa's offer as inadequate. In a subsequent two-hour meeting the board approved its selective self-tender after listening to reports about the proposed issuance of debt securities, the junk bonds, and the necessity of putting restrictive covenants on the company's activities until the obligations were paid.

The court determined these procedures were sufficient for the board to ascertain that Mesa's offer was inadequate and represented a threat to the

voting control. Once the acquiror has control, it merges the target with itself. The remaining stockholders receive low-rated securities worth less than the first step price. The load at the front end is the attractive tender offer. The acquiror hopes to create a stampede as shareholders scramble to avoid being squeezed out in the second step. Comment, *Corporate Law—Unocal Corp. v. Mesa Petroleum Co.: The Selective Self-Tender—Fighting Fire With Fire*, 61 NOTRE DAME L. REV. 109, 110 n.11 (1985).

In a selective self-tender, the target buys back its own stock for cash, but excludes the acquiror. Although the Delaware court upheld the selective feature of Unocal's self-tender, the SEC has proposed rule 14(d)-10 to prohibit selective dealing. Proposed Amendments to Tender Offer Rules, Exchange Act Release No. 34-22,198, 50 Fed. Reg. 27,978 (July 9, 1985); see Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?*, 19 GA. L. REV. 281, 282 (1985); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 113-14 (1979).

61. 493 A.2d at 956.

62. *Id.*

63. *Id.* at 951.

64. *Id.*

65. *Id.* at 957.

corporation.⁶⁶ The directors met their duty to act in the best interest of the stockholders by showing good faith and reasonable investigation. The court also held that Unocal's defensive response, the selective self-tender, was within the directors' legal competence and was not motivated by a desire to perpetuate themselves in office.⁶⁷

Perhaps the most significant outcome of *Unocal* was the court's recognition that the business judgment rule may function differently in a control contest than in other situations.⁶⁸ Although the court affirmed in principle that the rule could apply equally in all situations, the court observed that directors invariably have mixed motives in deciding how and if to fight takeovers.⁶⁹ This potential conflict of interest creates an enhanced duty calling for judicial scrutiny before the court extends protection under the business judgment rule. Thus, *Unocal* reversed the burden of coming forward in a control contest to the extent that directors must first show that they were justified in believing the takeover attempt presented a danger to the corporate enterprise.⁷⁰ A board meets this burden by showing good faith investigation.⁷¹

The *Unocal* court also determined that the reasonableness of the defensive measure must be weighed against the perceived threat.⁷² That is, the directors must balance the threat against the cost of defense.⁷³ The court considered the impact of the board's decision on constituencies other than shareholders as an example of concerns directors may take into account in balancing the response to the threat.⁷⁴ The court returned to this factor in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*⁷⁵

66. *Id.* at 958-59.

67. *Id.* at 956.

68. See Greene & Palmiter, *supra* note 16, at 510 (true significance of *Unocal* is recognition that the business judgment rule works differently in takeovers than in other board activity, and directors must meet more stringent standards in takeovers). For further treatment of this distinction see *infra* note 70. But see Lesser, *supra* note 7, at 19, col. 1 (mistaking dictum for holding that directors' responsibility is same in takeovers as in other situations).

69. 493 A.2d at 954.

70. The significance of *Unocal* is twofold. First the directors bear the initial burden of proving they had reasonable ground for believing a threat to the corporate enterprise existed. See *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1986). The *Unocal* court also implied that a board should take an active role in a takeover. 493 A.2d at 955. Scholars have hotly debated this issue. See *id.* at 954 n.9 for a list of articles addressing the issue. The chief proponent of directors' taking an active role is Professor Lipton, see Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 113 (1979), while Professors Fischel and Easterbrook argue that boards should take no action against takeover attempts, see Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981). For a list of other articles by these authors on this subject see Prentice, *Target Board Abuse of Defensive Tactics: Can Federal Law Be Mobilized to Overcome the Business Judgment Rule?*, 8 J. CORP. L. 337, 339 n.13 (1983).

71. 493 A.2d at 955.

72. *Id.*

73. *Id.*

74. *Id.*

75. 506 A.2d 173, 180 (Del. 1986); see *infra* notes 106-11 and accompanying text.

E. Moran v. Household International, Inc.

In *Unocal* the supreme court upheld a controversial defensive factor in the heat of an actual takeover contest. The same court soon thereafter considered a corporation's defensive action taken as a preventive mechanism before a takeover was imminent. In *Moran v. Household International, Inc.*⁷⁶ Household International, nervous because of its undervalued stock, devised a poison pill in the form of a preferred stock rights plan. One of the directors of the company opposed this plan and sued to have it overturned.

As with *Unocal*, the *Moran* court carefully evaluated the steps taken by the directors to inform themselves before adopting the preferred stock rights plan.⁷⁷ The court found that the directors made an informed decision reached only after extended discussions with attorneys and investment bankers.⁷⁸ The court applied the *Van Gorkom* duty of care standard⁷⁹ and upheld the plan as reasonable in relation to the threat posed in the service industry by takeovers.⁸⁰ The *Moran* court, concluding that the directors adopted the plan in good faith and in an informed manner, gave the directors the benefit of the business judgment rule.⁸¹

The *Moran* court discounted Moran's argument that Household International's plan made it takeover-proof by pointing out that several ways existed for getting around the poison pill.⁸² Moran also argued that the plan could not meet the *Unocal* requirement of being reasonably related to a threat since no takeover threat actually existed. The court, however, praised the virtues of Household International's advanced planning.⁸³ The court stated that although some takeover threat to the company must exist for directors to take advantage of the business judgment rule, preplanning such as Household International's reduces the chance of a hasty decision made under

76. 500 A.2d 1346, 1349 (Del. 1985).

77. *Id.* at 1356.

78. *Id.*

79. *Id.* at 1349. *Van Gorkom* required that the court find directors grossly negligent before impugning their business judgment. 488 F.2d at 873.

80. 500 A.2d at 1356-57. Household is a diversified holding company some of whose subsidiaries are engaged in financial services and other service-oriented businesses. Since breakup of the diversified company would be relatively easy and profitable and since Household's stock was undervalued, the directors reasonably feared the company was an attractive target. *Id.* at 1349.

81. *Id.* at 1357.

82. *Id.* at 1354. The court speculated that to overcome the effects of a poison pill an acquiror might tender on condition that the target redeem the pill, tender and try to solicit removal of the board, form a group holding enough shares to force a proxy removal of the board, or acquire one-half of the outstanding shares causing the target to self-tender for the stock rights. *Id.*

83. *Id.* at 1350. The use of poison pills appeared secure after *Moran*. Recently, however, the legal community has begun to doubt that pills will survive further judicial scrutiny. See Blumenthal, *Anti-Takeover Measure of NL Is Struck Down*, Wall St. J., Aug. 6, 1986, at 4, col. 2 (New York federal judge struck down poison pill, casting doubt on *Moran* holding); Waldman, *Skadden, Arp's Poison-Pill Stance Raises Conflict-of-Interest Concern*, Wall St. J., July 23, 1986, at 21, col. 3 (law firms accustomed to drafting poison pills uncertain as to their constitutionality). The SEC has solicited public comment on use of poison pills in an attempt to ascertain if federal intervention is appropriate. [Current] FED. SEC. L. REP. (CCH) ¶ 84,018 (July 31, 1986).

pressure.⁸⁴

After *Moran* the Delaware Supreme Court seemed to have laid the foundation for a readjusted business judgment rule. *Van Gorkom* defined the gross negligence standard of directors' duty of care. *Unocal* shifted the burden of coming forward from the plaintiff to the defendant, yet also reaffirmed a board's flexibility in countering threats to the corporate enterprise. *Moran* approved a poison pill adopted as a preventive defense. The decisions in *Unocal* and *Moran* had apparently dampened the harsh result of *Van Gorkom* by the time talks began in June between Revlon and Pantry Pride.

II. *REVLON, INC. V. MACANDREWS & FORBES HOLDINGS, INC.*

In *Revlon* the Delaware Supreme Court considered two issues of first impression in the context of a control contest. First the court defined the circumstances in which adoption of a lock-up option, a poison pill, and a cancellation fee are valid and protected by the business judgment rule.⁸⁵ Second, the court prescribed the extent to which a board may consider the impact of its decisions on constituencies other than shareholders.

The *Revlon* court began by reaffirming the special nature of a bidding contest. Since mergers and takeovers always threaten a director's continued employment on a corporate board, a conflict of interest is inevitable between a director's duty to the stockholders and his or her desire to continue in office.⁸⁶ For this reason courts will scrutinize directors' acts more closely in a control contest, and will place upon the directors the initial burden of proving that they had reasonable grounds for believing a danger existed to corporate policy and effectiveness.⁸⁷ Directors may satisfy this burden with a showing of good faith and reasonable investigation.⁸⁸ Once the directors have made this showing, they must go one step further and show that they made a reasonable defensive response with respect to the threat posed.⁸⁹

As it had done in earlier cases the *Revlon* court carefully examined the board's procedures for approving the poison pill, the note purchase rights plan.⁹⁰ The court first found that the conclusion of Revlon's board that Pantry Pride's \$45 offer was inadequate was reasonable based on information the board received from outside financial advisors.⁹¹ That the board obtained additional information from financial advisors as to how Pantry Pride would finance the takeover constituted, in the court's mind, a sufficient showing of

84. 500 A.2d at 1350.

85. 506 A.2d at 176. For other discussions of the *Revlon* case see Block & Barton, *Boards' Role in 'Hanson' and 'Revlon,'* Nat'l L.J., Apr. 21, 1986, at 19, col. 4; Veasey, *Business Judgment Rule, The New Incarnation,* Legal Times, Mar. 10, 1986, at 25, col. 1; Fleischer & Golden, *supra* note 6, at 17, col. 2; Lesser, *supra* note 7, at 17, col. 1; Levin, *Beware of Poison Pill After-Effects: the Revlon Case,* N.Y.L.J. Dec. 9, 1985, at 33, col. 2.

86. 506 A.2d at 180.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.* at 180-81.

91. *Id.*

good faith and a reasonable investigation of the threat posed.⁹² The note purchase rights plan, moreover, protected the corporation in a manner consistent with the directors' fiduciary duty to the stockholders. The court found that Pantry Pride's raising its bids from the low \$42 to an eventual high of \$58, primarily because of the poison pill, proved this point.⁹³

The court reached a similar conclusion about the notes plan. The court reasoned that when the board adopted the notes plan at the August 29 board meeting, the plan was reasonable in relation to the threat posed, and the board implemented the plan only after a good faith investigation.⁹⁴ The board's actions of October 3 and October 12, however, negated any further usefulness of the rights and notes plans. On those dates the directors resolved to redeem the note purchase rights, thus ending the plans' usefulness as impediments to hostile takeovers. More importantly, the board acknowledged the inevitable sale of the company by authorizing the search for a white knight. With the decision to negotiate with a white knight the directors' role changed from that of defenders of a corporation to auctioneers responsible for obtaining the best price for the company.⁹⁵

In assessing the lock-up and no-shop agreements with Forstmann the court focused not on the directors' duty of care in making reasonable evaluations, but on their duty of loyalty. Once the company was up for sale, any motivation other than obtaining the best price for the stockholders conflicted with the board's duty of loyalty.⁹⁶ The court observed that a company could utilize a lock-up option only to entice an otherwise unwilling white knight to enter the bidding, thus benefitting the stockholders.⁹⁷ When the lock-up ends the bidding, however, it operates to the stockholders' detriment and is impermissible.⁹⁸

The *Revlon* court followed the reasoning of the Second Circuit in *Hanson Trust PLC v. ML SCM Acquisitions, Inc.*⁹⁹ for their ruling on the lock-up option. In *Hanson* the target company's management had a strong self-interest in the lock-up, and the board failed to make sure that negotiations were conducted only by those directors loyal to the shareholders.¹⁰⁰ The

92. *Id.* at 181.

93. *Id.* The court reasoned that Pantry Pride raised its bid in response to Revlon's rights and notes plans.

94. *Id.* Up to this point, the court's determination was a predictable application of its analysis in *Unocal* and *Moran*.

95. 506 A.2d at 182. The court stated that "[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *Id.* The justification of the *Unocal* and *Moran* decisions in protecting the corporate enterprise disappears when the company is on the auction block. Any action by the board inconsistent with obtaining the highest price at a sale lacks the rational business purpose that underlies the business judgment rule. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. Ch. 1971); see also *Greene & Palmiter*, *supra* note 16, at 53 (courts will not disturb directors' actions if rational business purpose shown).

96. 506 A.2d at 182.

97. *Id.* at 183.

98. *Id.*; see Note, *Lock-Up Options*, *supra* note 9, at 1081.

99. 781 F.2d 264 (2d Cir. 1986).

100. The Second Circuit decided *Hanson* after the Delaware Supreme Court had an-

Revlon court likewise questioned the directors' motives for preferring Forstmann's offer to Pantry Pride's.¹⁰¹ Because the difference in price between the two offers was miniscule, the court concluded that the board's only justification for granting the lock-up option was to protect the noteholders.¹⁰² Reassuring the noteholders might relieve the directors of a troublesome source of personal liability, but would produce no benefit for the stockholders.¹⁰³ The court refused to uphold the lock-up agreement because the directors could demonstrate neither absence of self-interest nor any significant improvement in the final bid.¹⁰⁴ The court enjoined the no-shop agreement for virtually the same reasons.¹⁰⁵

In the second part of its opinion the court considered the circumstances in which a board may consider the interests of corporate constituencies other than stockholders in a takeover situation.¹⁰⁶ In defending the lock-up option the *Revlon* directors argued that the *Unocal* decision permitted consideration of nonstockholders and that the lock-up agreement protected the noteholders who would receive new notes bolstered to the original value of the old notes.¹⁰⁷ The *Revlon* court observed that by making protection of the notes an integral part of the agreement with Forstmann, the directors were protecting themselves from threatened litigation by angry noteholders.¹⁰⁸ Thus, the conflict of interest, always present in a takeover struggle, increased, enhancing the burden on the directors to justify their actions in terms of benefit to the stockholders.¹⁰⁹

Although the court conceded that a board may sometimes consider constituencies other than stockholders in a control contest, when the contest becomes an auction, according to the court, such considerations are inappropriate.¹¹⁰ The court held that before directors may consider other corporate constituencies in a takeover situation, the board must first demonstrate that

nounced its decision in *Revlon*, but before it issued its written opinion. In *Hanson* the Second Circuit tempered use of the business judgment rule in a control contest under New York law. *Id.* at 280-81. The Second Circuit, in effect, enunciated a stricter standard of care than the gross negligence standard defined in *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). The federal court enjoined a lock-up option and other agreements with a white knight similar to those used in *Revlon*. 781 F.2d at 283. According to *Hanson*, particularly when directors' decisions are likely to affect shareholder welfare, the directors' duty of care requires that decisions be made on the basis of reasonable diligence in gathering and considering material information. *Id.* at 274.

SCM argued that the directors approved the lock-up option to spur the bidding. The court, however, agreed with the district court's finding that the directors knew or should have known that the lock-up option would end the bidding. "The directors thus face the difficult task of justifying a lock-up option that is suspect for foreclosing bidding and for thereby impinging upon shareholder decisional rights regarding corporate governance." *Id.* at 281 (citations omitted).

101. 506 A.2d at 184.

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.* at 182.

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.* at 183.

the stockholders derive some rationally related benefit from the decision.¹¹¹ Since the principal benefit of the Forstmann agreement went to the directors and no rationally related benefit fell to the shareholders, the board's action failed to withstand the enhanced scrutiny required in a control contest.

III. CONCLUSION

In *Revlon* the Delaware Supreme Court distinguished in a takeover contest a board's role in defending the corporate enterprise from its duty to sell the company at the highest price. The court held that innovative defensive measures are reasonable and justified if adopted to preserve the corporation. Once sale of the company becomes inevitable, however, such measures are justified only insofar as they may produce a better price for the stockholders.

This holding forces directors to make yet another hindsight determination. Not only must directors predict whether a judge will find that their response to a hostile takeover was reasonable in relation to the threat, as required by *Unocal*, they must now also attempt to determine when they have passed from defending to selling the corporation. The court did not define what acts suffice to indicate that a company is on the auction block.

One possible consequence of *Revlon* is that the decision may have removed the lock-up option from serious consideration in future takeover contests. A lock-up option is an inducement to a third party to buy the company. Since granting the option amounts to announcing the sale of the company, a Delaware court will uphold the option only to the extent directors can show that the lock-up option produced a higher price. Directors can make this showing only if the acquiror makes a higher counteroffer, but an acquiror will probably not make such a counteroffer if the lock-up option is enforceable. Thus, either the third party buys the company or the court will not uphold the option. Either way, the option appears worthless.

The *Revlon* court also held that directors may not consider constituencies other than shareholders in a takeover contest unless some rationally related benefit accrues to the shareholders. This holding seems to nullify that part of the *Unocal* decision permitting consideration of nonstockholder constituencies. If taken literally, this holding forces directors in a takeover contest to demonstrate a benefit to shareholders before taking any action affecting other corporate constituencies even if the action does not adversely affect shareholders. Whether Delaware courts will follow the *Revlon* holding that strictly remains to be seen.

David S. White

111. *Id.*

