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Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions

Stephen M. Bainbridge*

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INTRODUCTION

When measured by dollar amount, the 1980s saw the largest wave of corporate acquisitions in our economic history.¹ The rise in takeover activity, the rapid evolution of offensive and defensive tactics, and the resulting barrage of litigation have strained the ability of courts and legislatures to respond effectively — decisionmakers often must feel as though they are again law students faced with a professor who relentlessly keeps changing the hypothetical to undermine the previous answer. An especially problematic example of this phenomenon is the role of performance promises, cancellation fees, and lock-ups in negotiated corporate acquisitions.

Performance promises, cancellation fees, and lock-ups developed as a response to the substantial risk that the parties en-

1. CHAIRMAN OF THE SUBCOMM. ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE OF THE HOUSE COMM. ON ENERGY AND COMMERCE, 99TH CONG., 2D SESS., CORPORATE TAKEOVERS: PUBLIC POLICY IMPLICATIONS FOR THE ECONOMY AND CORPORATE GOVERNANCE 2 (Comm. Print 99-QQ 1986). Most studies have found that the number of transactions identifiable as negotiated acquisitions significantly exceed those identifiable as hostile. *See, e.g., id.* at 28; Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117, 120 (1986) (observing that a Robert Comment and Gregg Jarrell study demonstrated a high frequency of negotiated tender offers). *But cf.* SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, TENDER OFFER DISCLOSURE AND FAIRNESS ACT OF 1987, S. REP. NO. 265, 100th Cong., 1st Sess. 9 (1987) (contested tender offers represented only 2.8% of the number of transactions studied, but accounted for 44.4% of their value). Among negotiated acquisitions, the merger probably remains the dominant acquisition technique. *See* Knoeber, *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, 76 AM. ECON. REV. 155, 155 n.1 (1986) (noting that mergers are a more predominate acquisition type, while tender offers reached an apparent high of 15% of all acquisitions in 1977 and had fallen to 4% by 1982).

Because it is often difficult to distinguish between purely friendly transactions and purely hostile transactions, this Article uses the following generic terms with some caution and mainly for convenience: "negotiated acquisition" shall refer to all changes in corporate control in which the target's board of directors determines (either initially or ultimately) not to resist the proposed acquisition; "merger" shall refer to all forms of negotiated acquisitions; and "merger agreement" shall refer to all agreements implementing a negotiated acquisition.

tering a negotiated merger agreement will not consummate the merger.² This risk is inherent in the negotiated acquisition process. A two to four month delay typically transpires between the signing of the merger agreement and the closing,³ which provides ample opportunity for intervening events to hinder the merger. Changes in the business environment occasionally may lead the target board to renege. Competition is an even greater risk.⁴ Another party may approach the target board

2. In a negotiated Single Bidder acquisition, the type of transaction with which this Article is principally concerned, the target corporation negotiates with only one prospective acquirer at a time. If the parties agree to basic terms, preliminary discussions typically conclude with the signing of a letter of intent addressed to the target. J. FREUND, *ANATOMY OF A MERGER* 59-65 (1975); Molod, *Forms and Paperwork*, in *THE MERGERS AND ACQUISITIONS HANDBOOK* 261, 261-63 (M. Rock ed. 1987). Negotiations usually continue after the agreement in principle is reached, and now center on preparation of a formal merger agreement. See generally J. FREUND, *supra*, at 53-389 (discussing in detail the negotiation process); Freund, *Merger Negotiations*, in *THE MERGER AND ACQUISITIONS HANDBOOK*, *supra*, 193, 193-200 [hereinafter Freund, *Merger Negotiations*] (discussing negotiation issues). Once a definitive agreement is in hand, the parties obtain requisite shareholder and regulatory approvals and, assuming the necessary approvals are forthcoming, proceed to closing. See generally J. FREUND, *supra*, at 419-48 (discussing closing issues).

Exclusive merger agreements are also common in Multiple Bidder transactions, in which at least two acquisition proposals are pending when the target agrees to be acquired by one of the competing bidders. A Multiple Bidder contest is typically triggered by the mere announcement of the initial unsolicited bid from a prospective acquirer, which leads other, unsolicited offerors (gray knights) to enter the bidding. Alternatively, the target may affirmatively invite a more friendly bidder (a white knight) to enter the contest.

3. This delay period is necessitated by, among other things, the need to obtain shareholder, and perhaps also regulatory, approval, prepare and file a detailed proxy statement, register and list any securities to be issued in connection with the acquisition, and take other necessary steps. Although the delay between signing the merger agreement and closing the transaction can be reduced by efficient execution of those steps, it cannot be eliminated in light of various statutory time limits. See, e.g., 17 C.F.R. § 240.14a-6(a) (1990) (proxy statement may not be mailed until at least 10 days after the preliminary statement is filed with the Securities and Exchange Commission (SEC)); DEL. CODE ANN., tit. 8, § 251(c) (1988) (requiring at least 20 days notice before shareholder meeting may be held). See generally Hart & Brodwin, *Merger Agreements in Takeover Contests*, 17 REV. SEC. REG. 779, 779 (1984) (noting that effecting a merger of publicly held companies "is usually a costly, complex, and time-consuming process"); Note, *Target Directors' Fiduciary Duty Overrides Contractual Duty in Merger Contracts*, 12 J. CORP. L. 735, 737 (1987) [hereinafter Note, *Merger Contracts*] (observing that merger negotiation may take "weeks or even months," and that "final shareholder approval takes at least three to four months from the time the merger proposal is first announced").

4. See, e.g., Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CALIF. L. REV. 1671, 1712 (1985); Freund, *Merger Negotiations*, *supra* note 2, at 196; Hart & Brodwin, *supra* note 3, at 779; Herzl, Colling &

with an alternative, presumably higher-priced, acquisition proposal; indeed, target management might initiate negotiations with a second party before presenting the initial bid to the shareholders. Alternatively, a competing bidder may directly present its proposal to target shareholders by making a tender offer for their shares.⁵

The substantial risk of nonconsummation is especially important to the prospective acquirer, which incurs substantial up-front costs in making the initial offer.⁶ Depending on the circumstances, the initial bidder may incur significant search costs to identify an appropriate target. Once an appropriate target is identified, preparation of the offer typically requires the services of outside legal, accounting, and financial advisers. If the bidder will pay all or part of the purchase price from sources other than cash reserves, a likely scenario, the bidder also incurs commitment and other financing fees. Finally, the bidder may pass up other acquisition opportunities while negotiating with the target. Although the bidder will recover these up-front costs if the parties consummate the merger, the emergence of a competing bid may eliminate or reduce the bidder's expected return on its sunk costs: Second bidders apparently prevail in a substantial majority of competitive bidding contests⁷ and, even if the initial bidder prevails, the ultimate acquisition price is likely to be substantially higher than the initial bid.⁸

The exclusive merger agreement partially responds to

Carlson, *Misunderstanding Lock-ups*, 14 SEC. REG. L.J. 150, 152-53 (1986). Professor Leebron, however, estimates "that at most only about 20% of the tender offers that are meaningfully open to second bidders result in an actual second bid." Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153, 195 n.144 (1986).

5. See Herzel & Shepro, *Negotiated Acquisitions: The Impact of Competition in the United States*, 44 BUS. LAW 301, 303 (1989).

6. See Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 3-7 (1982) [hereinafter Easterbrook & Fischel, *Auctions*] (discussing "sunk information costs"); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1178-79 (1981) [hereinafter Easterbrook & Fischel, *Proper Role*] (same); Helman & Davis, *Merger and Acquisition Agreements in Competitive Bidding Situations: Rights and Obligations Created by Corporation and Contract Law*, 17 SEC. REG. L.J. 3, 10-11 (1989).

7. See Ruback, *Assessing Competition in the Market for Corporate Acquisitions*, 11 J. FIN. ECON. 141, 147 (1983) (second bidders prevailed in 75% of the 48 cases examined).

8. See Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 283 (1984); Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merger?*, 28 J. L. & ECON. 151, 174

these risks because it discourages the target board from reneging on the merger agreement or, at the least, reimburses the favored bidder's up-front costs if the parties do not consummate the merger.⁹ The operative provisions of exclusive merger agreements may be conveniently divided into two basic categories: performance promises, an agreement between the target board and the bidder board that the parties will engage (or not engage) in certain types of conduct prior to the shareholder vote on the proposed merger; and cancellation fees, typically a specified amount the target agrees to pay the favored bidder if the transaction does not go forward.

Performance promises consist of best efforts covenants and various forms of no-shop covenants. A best efforts covenant requires both parties to use their "best efforts" to consummate the transaction.¹⁰ The covenant also usually requires the target

(1985) (noting the ultimate acquisition of a target typically comes at an additional 17 points after an auction).

9. Corporation statutes generally require a merger agreement to contain provisions relating to the terms and conditions of the transaction and the manner of payment, but also permit the parties to include such other terms and provisions as they see fit. *See, e.g.*, MODEL BUSINESS CORP. ACT ANN. § 11.01 comment (1985); DEL. CODE ANN., tit. 8, § 251 (1988). *See generally* J. FREUND, *supra* note 2, at 153-61, 229-324 (categorizing and discussing additional terms parties may desire); Johnson & Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PENN. L. REV. 315, 351-53 (1987) (listing examples of "collateral covenants" that may be included in a merger agreement); Molod, *supra* note 2, at 263-65 (same).

10. A typical best efforts clause provides:

Subject to the terms and conditions provided herein, each of the parties agrees to use its best efforts to take, or cause to be taken, all action and to do, or cause to be done, all things necessary, proper or advisable under applicable law and regulation to consummate and make effective the Mergers in accordance with the terms of this Agreement [and Plan of Reorganization] and the Merger Agreements, subject, however, to the vote of shareholders [of each party]. In case at any time after the Merger Date any further action is necessary or desirable to carry out the purposes of this Agreement or the Merger Agreements, the proper officers or directors of [the parties] shall take all such action.

Agreement and Plan of Reorganization, as amended, among Allied-Signal Inc., Allied Corp., AC Acquisition Corp., and The Signal Companies, Inc., May 15, 1985, § 7.6 [hereinafter Allied-Signal Reorganization Agreement], *reprinted in* 3 M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZEOUTS F-84.2, F-84.21 (1987). In this context, "best efforts" imposes "at a minimum a duty to act in good faith toward the party to whom it owes a 'best efforts' obligation." *Jewel Cos. v. Pay Less Drug Stores N.W., Inc.*, 741 F.2d 1555, 1564 n.11 (9th Cir. 1984). *But see* *Great Western Producers Co-Op. v. Great Western United Corp.*, 200 Colo. 180, 186, 613 P.2d 873, 878 (1980) (en banc) (holding, under Delaware law, that a best efforts clause merely imposed an obligation to "make a reasonable, diligent and good faith effort"). *Jewel's* interpretation ar-

board and, typically, the bidder board¹¹ to recommend the merger to their respective shareholders.¹²

A no-shop covenant prohibits the target corporation from soliciting competing offers from other prospective bidders.¹³ The standard no-shop covenant, however, does allow the target to negotiate with an unsolicited competing bidder.¹⁴ In con-

guably is more consistent with the use of best efforts terminology in other contexts, where it often is defined to mean "maximizing the contractual benefits of the person to whom the duty is owed, even if the benefits to the one owing the duty have been depleted." See, e.g., *In re Heard*, 6 Bankr. 876, 884 (Bankr. W.D. Ky. 1980); see generally Farnsworth, *On Trying to Keep One's Promises: The Duty of Best Efforts in Contract Law*, 46 U. PITT. L. REV. 1, 8-10 (1984) (duty to use best efforts has diligence as its essence; one standard courts use "is to imagine the promisor and the promisee united in a single person and to ask what efforts a reasonable person in that situation would exert on his or her own behalf"); Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1111-26 (1981) (describing and applying a "best efforts model," imposing a greater burden than a mere good faith effort; addressing the problem of managerial incompetence); Note, *Merger Contracts*, *supra* note 3, at 740 (arguing that a best efforts clause imposes a greater burden than a good faith effort clause, as it is based on diligence and applies only to parties who agree to use best efforts to fulfill a contractual obligation).

11. See Note, *Merger Contracts*, *supra* note 3, at 740-41. Even in cases where approval by the bidder's shareholders is not required, such as in a triangular merger, the favored bidder may still agree to use its best efforts to assure that the transaction is consummated.

12. *Id.* at 736-37, 740-41 (citations omitted). See, e.g., *Jewel*, 741 F.2d at 1555; *ConAgra, Inc. v. Cargill, Inc.*, 222 Neb. 136, 382 N.W.2d 576 (1986) (*per curiam*). A typical version states that the target's board of directors shall:

recommend that the stockholders . . . vote to adopt and approve the Merger . . . [and] use [their] best efforts to solicit from stockholders . . . proxies in favor of adoption and approval and . . . take all other action necessary or . . . helpful to secure a vote of stockholders in favor of the Merger.

Merger Agreement among United States Gypsum Co., Permalastic Prods. Inc., and Masonite Corp., Mar. 25, 1984, § 6.2 [hereinafter *Gypsum-Masonite Merger Agreement*], *reprinted in* Hart & Brodwin, *supra* note 3, at 780.

13. See, e.g., *Merger Agreement among Marcess Holding Co., Marcess Sub., Inc., and Esmark, Inc.*, May 4, 1984, § 5.6, *reprinted in* Hart & Brodwin, *supra* note 3, at 779 n.3:

The Company and its subsidiaries will not, directly or indirectly . . . solicit, initiate or encourage submission of proposals or offers from any person relating to any acquisition or purchase of all or . . . a portion of the assets of, or an equity interest in, the Company.

Id.

14. *Nachbar, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. — The Requirement of a Level Playing Field in Contested Mergers, and its Effect on Lock-ups and Other Bidding Deterrents*, 12 DEL. J. CORP. L. 473, 480 (1987). The no-shop clause may, however, require the target to notify the acquirer if an inquiry or proposal is received. S. REED & LANE AND EDSON, P.C., *THE ART OF M & A: A MERGER, ACQUISITION, BUYOUT GUIDE* 640 (1989) [hereinafter S. REED].

trust, the no negotiation covenant, a variant on the no-shop theme, prohibits such negotiations.¹⁵ An intermediary version, the no merger provision, permits the target to negotiate with an unsolicited competing bidder, but prohibits it from entering a merger agreement with the competitor until the shareholders vote on the initial bid.¹⁶ The initial bidder will virtually always request, and the target will usually grant, a no-shop covenant, or one of its variants.¹⁷

Cancellation fees are essentially liquidated damages the target agrees to pay the initial bidder on the occurrence of a specified trigger event.¹⁸ The trigger event commonly is the acquisition of a specified amount of target stock by a third party.¹⁹ Variants include target termination of the merger

15. The Gypsum-Masonite Merger Agreement, *supra* note 12, § 6.6, provided:

[the target company shall not] participate in any negotiations regarding, or furnish to any other person any information with respect to, or otherwise cooperate in any way with, or assist or . . . participate in, facilitate or encourage, any effort or attempt . . . to do or seek [to acquire a substantial part of the assets or equity of the company].

See also Allied Signal Reorganization Agreement, *supra* note 10, § 7.7(a) (prohibiting the parties from taking action that would "directly or indirectly, encourage, solicit or initiate discussions or negotiations with or knowingly provide any non-public information to [a non-party] concerning any merger, sale of substantial assets, sale of shares of capital stock or similar transactions involving [any of the parties]").

16. Johnson & Siegel, *supra* note 9, at 353 n.130.

17. S. REED, *supra* note 14, at 754. In addition, the acquirer usually requests a covenant prohibiting the furnishing of confidential information to a prospective competing bidder. These dissemination of information clauses typically provide that the target will not provide internal financial information to any third party until either the bid is accepted or some specified period of time lapses. See, e.g., Gypsum-Masonite Merger Agreement, *supra* note 12, § 6.6; Allied Signal Reorganization Agreement, *supra* note 10, § 7.7(b).

18. Johnson & Siegel, *supra* note 9, at 354 n.132 (noting that such arrangements may be called a "break-up fee, bust-up fee, termination fee, or penalty clause"); Nachbar, *supra* note 14, at 485 (noting such "reasonable break-up fees"). A variation of the cancellation fee arrangement, closely akin to stock lock-ups, involves giving an option to the acquirer pursuant to which the acquirer has the right to purchase a specified number of target shares and also a right to resell those shares to the target at a price higher than the exercise price in the event that an alternative bid is accepted. See A. MICHEL & I. SHAKED, *THE COMPLETE GUIDE TO A SUCCESSFUL LEVERAGED BUYOUT* 240 (1988).

19. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 178 (Del. 1986) (demand that the target place a \$25 million cancellation fee in escrow to be released to the bidder if another party acquired more than 19.9% of Revlon's stock); *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 269 (2d Cir. 1986) (observing that the target was to pay a \$9 million "break-up" fee to the white knight "in the event that any third party should acquire one third or more" of the target's outstanding common stock).

agreement,²⁰ and shareholder rejection of the acquisition proposal.²¹ Cancellation fee provisions typically require the target to pay the bidder a specified dollar amount. In contrast, topping fee provisions, a relatively recent variation on the basic theme, require the target to pay the defeated initial bidder a percentage of the victorious bidder's acquisition price.²² In both cases, the fee ordinarily ranges from one to five percent of the proposed acquisition price.²³ A cancellation fee reduces the risk of entering a negotiated merger by guaranteeing the initial bidder reimbursement for the out of pocket costs associated with making the offer and, in some instances, for the bidder's lost time and opportunities.²⁴ Accordingly, they are increasingly common in negotiated acquisitions.²⁵

Although a merger agreement containing exclusivity provisions is not the only method a potential acquirer can use to assure success, it may often be the most effective. Probably the most common alternative to an exclusive merger agreement is structuring the acquisition in two steps. The initial stage is a friendly tender offer for at least a majority of the target's shares. The second-step is a freezeout merger to eliminate the remaining minority shareholders.²⁶ In theory, the large block

20. See, e.g., *Cottle v. Storer Communication, Inc.*, 849 F.2d 570, 572 (11th Cir. 1988) (noting that the potential white knight who requested a \$3 million "hello fee" also requested an \$18 million "goodbye fee" if the target terminated the proposed merger); *Beebe v. Pacific Realty Trust*, 578 F. Supp. 1128, 1150 (D. Or. 1984) (observing that under the terms of the disputed agreement, the target has to pay the acquiring company 1% of the gross value of the proposal transaction, plus expenses, if the target terminated the merger).

21. See, e.g., *Friedman v. Baxter Travenol Laboratories, Inc.*, No. 8209, slip op. (Del. Ch. Feb. 18, 1986) (LEXIS, States library, Del file) (under merger agreement, target required to pay acquirer \$300 million if target's shareholders voted down the merger).

22. See, e.g., *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 777 (Del. Ch. 1988) (discussing a proposed merger agreement granting a losing bidder a topping fee of 20% of any amount over a set price per share that shareholders ultimately realized).

23. S. REED, *supra* note 14, at 753 (noting that "[t]he higher percentages apply to smaller to medium size public transactions").

24. White knights proposing a leveraged buyout of the target in response to a hostile takeover bid also frequently require an engagement fee, requiring the target to pay a relatively small fee as consideration for the white knight's preparation and submission of its bid. See, e.g., *Cottle*, 849 F.2d at 572 (observing that a potential white knight requested a \$3 million "hello fee"); *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 269 (2d Cir. 1986) (noting that the white knight requested a \$1.5 million "engagement fee").

25. See *Cottle v. Storer Communication, Inc.*, 849 F.2d 570, 578 (11th Cir. 1988); *Beebe v. Pacific Realty Trust*, 578 F. Supp. 1128, 1150 n.7 (D. Or. 1984).

26. See generally Freund & Easton, *The Three-Piece Suitor: An Alterna-*

of target stock acquired in the initial tender offer should prevent, or at least deter, subsequent bidders from entering the picture. This approach, however, is far from being a panacea. Current law builds a substantial amount of delay into this acquisition technique — leaving open a window of opportunity for second bidders. For example, Securities and Exchange Commission (SEC) Rule 14e-1 requires that a tender offer remain open for at least twenty days, with an additional ten-day extension after certain material changes.²⁷ Further delays are necessary when the consideration to be paid target shareholders includes securities which the Securities Act of 1933 requires the acquirer to register.²⁸ In addition, this approach reduces the amount of time available to conduct due diligence review. Finally, this approach may fail entirely when there are statutory or other obstacles to effecting the second-step merger.

Another alternative to the exclusive merger agreement is

tive Approach to Negotiated Corporate Acquisitions, 34 BUS. LAW. 1679 (1979) (discussing the three consecutive stages of the "multistep acquisition": the block purchase, the tender offer, and the cash merger). A "freezeout" is a transaction (normally a merger) by which the equity interests of minority shareholders are eliminated. Brudney & Chirldstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1357 (1978).

In addition, many bidders seek to prevent disclosure of the impending acquisition at least until an agreement in principle has been reached. Gabaldon, *The Disclosure of Preliminary Merger Negotiations as an Imperfect Paradigm of Rule 10b-5 Analysis*, 62 N.Y.U. L. REV. 1218, 1231-33 (1987). See also *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). In *Basic*, the Supreme Court held that a target may not make misrepresentations in connection with material preliminary merger negotiations, materiality being defined by "a highly fact-dependent probability/magnitude balancing approach." *Id.* at 238-39 n.16. *Basic*, however, did not impose an affirmative duty of disclosure in connection with material preliminary negotiations and, at least implicitly, permits a target to respond to inquiries with a "no comment" statement. *Id.* at 235, 239 n.17. Thus, the parties are probably still allowed to keep the transaction secret during the negotiating process. Cf. Securities Act Release No. 6,835 (May 18, 1989), reprinted in 43 SEC DOCKET 1577, at 1585-86 (1989) (management's discussion and analysis in annual reports need not disclose preliminary merger negotiations if doing so would jeopardize transaction, provided certain other conditions are satisfied).

27. 17 C.F.R. § 240.14e-1 (1990). See also 15 U.S.C. § 18a(b)(1) (1982) (Hart-Scott-Rodino Antitrust Improvement Act requires 15 day waiting period for certain cash tender offers).

28. See generally 15 U.S.C. §§ 77a-77aa (1987). The delay caused by federal requirements is compounded by state statutes requiring shareholder approval of the offer. See, e.g., *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 94 (1987) (upholding an Indiana control share acquisition statute that in effect imposes a minimum period of 50 days before a tender offer can be completed by requiring shareholder approval of the transaction for the acquired shares to have voting rights). See IND. CODE ANN. §§ 23-1-42-1 to 23-1-42-11 (West Supp. 1989).

open market purchases of substantial amounts of target stock prior to announcing the acquisition proposal. In theory, this approach locks in a profit for the initial bidder in the event the acquisition fails to go forward because the initial bidder can sell the shares bought at the relatively low pre-announcement price to the prevailing bidder or on the market. In reality, this option frequently is not fully satisfactory. Failing to approach the target before beginning a stock acquisition program may put a damper on subsequent negotiations. The target's management might justifiably view the bidder as having hostile intentions, despite its protestations to the contrary, and withhold cooperation.²⁹ Further, informing the target of one's intentions increases the likelihood of leaks and subsequent insider trading, which may rapidly drive up the stock price and reduce the profit margin available. Federal law also sharply limits the initial bidder's ability to assure itself a profit on its up-front expenses by means of pre-announcement purchases. While the insider trading laws generally do not apply to pre-announcement purchases by bidders,³⁰ section 13(d) of the Securities Exchange Act of 1934 and the SEC rules thereunder require a person or group to disclose their holdings and intentions within ten days after acquiring more than five percent of a class of registered equity securities.³¹

In light of the drawbacks inherent in the principal alternatives to merger agreements containing exclusivity provisions, it

29. See generally Herzel & Shepro, *supra* note 5, at 307 (noting that the target's management "may view the acquisition of a foothold position [i.e., a substantial block of stock] as a sour beginning with aggressive overtone, which may make a cooperative relationship with them difficult").

30. See Rosenbaum & Bainbridge, *The Corporate Takeover Game and Recent Legislative Attempts to Define Insider Trading*, 26 AM. CRIM. L. REV. 229, 240-41, 241 n.77 (1988) (noting that corporate raiders' practice of "routine[ly] purchas[ing] large blocks of target stock before announcing their intentions" is "perfectly legal").

31. 15 U.S.C. § 78m(d) (1988); 17 C.F.R. §§ 240.13d-1 to -7 (1990). Of course, some bidders are able to acquire considerably more than 5% of the target's shares by continuing to buy stock during the ten-day window before disclosure is required. See Rosenbaum & Bainbridge, *supra* note 30, at 240-41.

A further constraint is imposed by Securities Exchange Act of 1984, § 16(b), 15 U.S.C. § 78p(b) (1988), which requires beneficial owners of more than 10% of a class of registered equity securities to disgorge short-swing profits from matched purchases and sales within a six month period. For discussion of the effect of § 16(b) on acquisition transactions, see P. ROMEO, *INSIDER REPORTING AND LIABILITY UNDER SECTION 16 OF THE SECURITIES EXCHANGE ACT OF 1934* 73-84, 105-09 (1988); Note, *Short-Swing Profits in Failed Takeover Bids: The Role of Section 16(b)*, 59 WASH. L. REV. 895, 895-912 (1984) (analyzing the potential § 16(b) liability of unsuccessful takeover bidders).

is not surprising that the latter have become both common and controversial.³² If common practice was the sole (or even the primary) source of corporate law, the routine use of exclusivity provisions would be enough to validate them. Such has not proven to be the case. In recent years, exclusivity provisions have come under increasing fire from courts and commentators. Specifically, courts confronted with exclusivity provisions have struggled with the apparent inconsistency between a board's efforts to bind itself in advance of shareholder action and a board's fiduciary duties to its shareholders. A hodgepodge of rules resulted from this perceived inconsistency, which until recently narrowed the boundaries within which parties to a merger may use exclusivity provisions.

This Article argues that these approaches ask the wrong questions. Under modern corporate statutes, management acts as a gatekeeper — all forms of negotiated acquisitions require the target board's approval before shareholders may vote on the transaction. To obtain the board's cooperation, the bidder may offer management side payments, such as employment contracts containing enhanced benefits. In return, management may take action contrary to the shareholders' best interests, such as agreeing to an acquisition price below the price management could obtain through arms-length bargaining. Because of this potential for departures from sole allegiance to shareholder interests, exclusivity provisions, at first blush, appear unjustifiable. In today's takeover environment, however, the constant threat that a third party will make a competing bid before shareholder action on the negotiated merger proposal constrains management's potential conflict of interest.

The critical issue thus is not whether the target board has the power to grant exclusivity provisions, but what the board can do to prevent competing bids. As we shall see, exclusivity provisions, standing alone, cannot prevent a second bidder from making a competing offer. Unless the parties erect additional protections against competition, a competing bidder can easily bypass exclusivity provisions by making a tender offer directly to the target's shareholders. Considered in this light, the arguments against exclusivity provisions lose much of their force. Accordingly, this Article proposes a framework for analyzing

32. See *Keyser v. Commonwealth Nat'l Fin. Corp.*, 644 F. Supp. 1130, 1146 (M.D. Pa. 1986); *Beebe v. Pacific Realty Trust*, 578 F. Supp. 1128, 1150 n.7 (D. Or. 1984).

exclusivity provisions that defines and broadens the circumstances in which courts should enforce them.

Given the relative weakness of exclusivity provisions as a bidding deterrent, an additional device was necessary to insure that the favored bidder's acquisition proposal would succeed — one that would more effectively deter competing bids. Transaction planners found the necessary device in the lock-up. A lock-up is any arrangement or transaction through which the target gives the favored bidder a competitive advantage over other bidders.³³ So defined, the term includes an unusually large cancellation fee or an agreement by the target to use takeover defenses to protect the favored bid from competition. A lock-up option refers more narrowly to an agreement (usually separate from the merger agreement) granting the initial bidder an option to buy shares or assets of the target.³⁴ Like cancellation fees, a lock-up option commonly becomes exercisable when a third party acquires a specified percentage of the target's outstanding shares.³⁵

A stock lock-up option gives the favored bidder an option to purchase a specified number of treasury or authorized but unissued target shares. A stock lock-up option deters competing bids because of the risk that the favored bidder will exer-

33. See Fraidin & Franco, *Lock-Up Arrangements*, 14 REV. SEC. REG. 821, 829 (1981); Nathan, *Lock-ups and Leg-ups: The Search for Security in the Acquisitions Marketplace*, 13 ANN. INST. SEC. REG. 1, 4 (1982). In so-called shareholder lock-ups, the favored bidder enters into a lock-up arrangement, "running the gamut from stock purchase agreements and options to purchase stock to agreements to tender to the bidder or not to tender to others and voting agreements," with a target shareholder or shareholder group. 1 A. FLEISCHER, *TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING* 325 (1983); see S. REED, *supra* note 14, at 749. Shareholder lock-ups seem most likely to be successful in companies where a single shareholder or a cohesive shareholder group already owns a controlling (if not majority) interest in the target. In any event, these types of arrangements raise issues of controlling shareholders' fiduciary duties that are outside the scope of this Article.

34. 1 A. FLEISCHER, *supra* note 33, at 327-29; R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 798 (6th ed. 1987); Note, *Lock-Up Options: Toward a State Law Standard*, 96 HARV. L. REV. 1068, 1068-69 (1983).

35. See, e.g., *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 270 (2d Cir. 1986) (option allowed acquirer to purchase target's "crown jewel" division if offer did not succeed); *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 367 (6th Cir. 1981) (option allowed acquirer to purchase target's interest in oil and mineral rights at reduced price if the acquirer's offer did not succeed and outside party gained control of the target), *cert. denied*, 455 U.S. 982 (1982); *DMG, Inc. v. Aegis Corp.*, No. 7619, slip op. (Del. Ch. June 29, 1984), *reprinted in* 9 DEL. J. CORP. L. 437, 439 (1984) (option giving the acquirer the right to purchase 51% of the target's subsidiary if a third party purchased 40% or more of the target's stock).

cise the option, thereby driving up the number of shares that a competing bidder must acquire to obtain control, and thus increasing the overall acquisition cost. Even if the lock-up fails to deter competing bids, however, the option still benefits the favored bidder. If the bidder exercises the option prior to the shareholder vote on its merger proposal, the bidder can vote its shares in favor of the merger, helping to assure that its proposal is approved.³⁶ If a competing bidder prevails, the favored bidder can exercise the option and sell its shares on the open market or tender them to the successful bidder, thereby recouping some or all of its sunk costs.³⁷

An asset lock-up option grants the favored bidder an option to purchase a significant target asset. Although a target board may use an asset lock-up option to entice a prospective bidder, boards principally use them to end or prevent competitive bidding for the target. Accordingly, the subject of the option is usually either the assets most desired by a competing bidder or those essential to the target's operations.³⁸

This Article argues that the validity of both exclusivity provisions and lock-ups should turn on whether a given provision deters competing bids. Part I describes the judiciary's traditional methods of reviewing exclusivity provisions and lock-ups. Part II argues that maintaining a viable threat of competitive bidding — an "auction" of corporate control — is essential because it provides the best available check on the conflict of interest inherent in a board's decision to approve a favored bidder's acquisition proposal. Part III analyzes the current legal regime governing exclusivity provisions and lock-ups in light of that proposition, with an emphasis on the recent Delaware decisions in the Time-Warner-Paramount takeover contest.³⁹ Part IV then argues that exclusivity provisions and lock-ups are properly evaluated as a species of conflict of interest cases implicating the duty of loyalty. As such, the modified

36. S. REED, *supra* note 14, at 749.

37. *Id.*

38. See, e.g., *Hanson Trust*, 781 F.2d at 267 (option giving the bidder the right to purchase the target's "two most profitable businesses"). Asset lock-ups are sometimes referred to as "crown jewel options," the name coming from the notion that the asset subject to the option is the target's crown jewel, i.e., its most valuable or desirable asset. See, e.g., *Mobil*, 669 F.2d at 367; see generally L. SOLOMON, D. SCHWARTZ & J. BAUMAN, *CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS* 1060-61 (2d ed. 1988).

39. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990), *aff'd* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989).

business judgment analysis adopted by the *Time* courts is essentially misdirected. Accordingly, Part IV proposes a more coherent and workable framework for judicial review of exclusivity provisions and lock-ups that minimizes the opportunities for self-interested behavior by target managers in acquisition settings.

I. TRADITIONAL METHODS OF JUDICIAL REVIEW

Courts traditionally evaluated exclusivity provisions pursuant to one of two methodologies. The first method asks whether the target board, consistent with its fiduciary duties, has the power to make binding performance promises or cancellation fee arrangements before shareholder action on the merger proposal.⁴⁰ The second method assumes target board power to enter exclusivity provisions, and rather focuses on whether the board followed appropriate procedures before it decided to grant the exclusivity provisions.⁴¹ Some courts also use this second method to evaluate lock-ups, consistently assuming target board power to enter lock-ups.⁴²

A. THE EXCLUSIVE MERGER AGREEMENT AS BINDING CONTRACT

The handful of reported decisions raising the contractual effect of an exclusive merger agreement almost uniformly involve the same basic fact pattern. The transaction begins as a Single Bidder acquisition with the favored bidder persuading the target board to include a best efforts clause, and perhaps also a no-shop or cancellation fee provision, in the definitive merger agreement. A competing bidder then makes a higher offer for the target, and the favored bidder claims that the new offer constitutes tortious interference with contract.⁴³ If the

40. See *infra* Part I. A.

41. See *infra* Part I. B.

42. See *infra* notes 118-35 and accompanying text.

43. See, e.g., *R-G Denver, Ltd. v. First City Holdings of Colo., Inc.*, 789 F.2d 1469, 1471-73 (10th Cir. 1986); *Jewel Cos. v. Pay Less Drug Stores N.W., Inc.*, 741 F.2d 1555, 1557-58 (9th Cir. 1984) (best efforts and no-shop clauses); *ConAgra, Inc. v. Cargill, Inc.*, 222 Neb. 136, 137-39, 382 N.W.2d 576, 577-79 (1986) (per curiam); *Belden Corp. v. InterNorth, Inc.*, 90 Ill. App. 3d 547, 550, 413 N.E.2d 98, 102 (1980); cf. *Great Western Producers Co-Op. v. Great Western United Corp.*, 200 Colo. 180, 182-84, 613 P.2d 873, 875-77 (1980) (en banc) (despite best efforts clause, changed business conditions led target board to renege).

The tort of intentional interference with contract imposes liability on an actor who intentionally and improperly interferes with the performance of an

target board switches sides, perhaps by refusing to recommend shareholder approval of the initial bid, the favored bidder adds the target as a defendant, claiming breach of the best efforts covenant. Central to both claims is the validity and binding effect of the exclusivity provisions. Only if these provisions are binding on the target in advance of shareholder action will either the competing bidder or the target face liability. This issue has proven to be surprisingly complex. While all courts agree that a merger agreement may not require shareholders to approve the merger, courts are sharply divided over the extent to which a target board may otherwise seek to insure merger consummation.⁴⁴

In theory, the enforceability of exclusivity provisions turns on "a delicate interplay of principles of both contract and corporate law, neither wholly controlling the outcome."⁴⁵ The basic contract issue posed by exclusivity provisions is whether shareholder approval of the merger is a condition precedent to the formation of the agreement or merely to the target's duty to complete the transaction. Only in the latter case could the board make binding promises as to its own behavior prior to shareholder approval.⁴⁶ Although the majority view among commentators appears to be that exclusivity provisions are enforceable as a matter of contract law during the interim before

enforceable contract between plaintiff and a third party by inducing or otherwise causing the third party not to perform the contract, thereby giving rise to a pecuniary loss on the part of the plaintiff. See RESTATEMENT (SECOND) OF TORTS § 766 (1979). See generally Perlman, *Interference with Contract and Other Economic Expectancies: A Clash of Tort and Contract Doctrine*, 49 U. CHI. L. REV. 61, 61-69 (1982) (describing the tort of intentional interference with contract).

The tort of interference with prospective business advantage will rarely be applicable to exclusive merger agreement litigation, because fair economic competition is typically a defense to such claims. See *Belden*, 90 Ill. App. 3d at 547, 413 N.E.2d at 101-03; Johnson & Siegel, *supra* note 9, at 360-61 n.158; Note, *Merger Contracts*, *supra* note 3, at 748. See generally Loewenstein, *Tender Offer Litigation and State Law*, 63 N.C.L. REV. 493, 497-514 (1985) (describing the tort of interference with prospective business advantage and defenses to the tort).

44. See *infra* note 48 and accompanying text.

45. *ConAgra*, 222 Neb. at 153, 382 N.W.2d at 586.

46. See Johnson & Siegel, *supra* note 9, at 355; Milich, *Exclusive Merger Agreements: The Role of the Board of Directors*, 13 J. CORP. L. 823, 831 (1988); Note, *Merger Contracts*, *supra* note 3, at 739. The mere fact that the merger agreement requires shareholder approval or contains a best efforts clause is not itself sufficient to render the agreement unenforceable as a matter of contract law. *Id.* at 739-40.

shareholder action,⁴⁷ courts have not reached consistent conclusions.⁴⁸

In practice, most courts have ignored or only paid lip service to contract law concerns, instead focusing on the corporate law aspects of exclusivity provisions. In so doing, the courts have received little direct statutory guidance. Modern corporation codes are generally silent on the effect of a merger agreement pending shareholder approval.⁴⁹ Some courts thus have sought inferential guidance from potentially analogous statutory provisions. This search has not produced consistent results. The primary statutory provision to which courts have looked for guidance is the abandonment provision, which permits a target board to abandon a merger or asset sale that has received shareholder approval, subject to the contractual rights of any third parties, without the need for further shareholder action.⁵⁰ The Colorado Supreme Court found that the abandonment clause in the Delaware asset sale statute supported its conclusion that a target board may not lawfully bind itself to a proposed control transaction by means of exclusivity provi-

47. See, e.g., Johnson & Siegel, *supra* note 9, at 359; Ward, *The Legal Effects of Merger and Asset Sale Agreements Before Shareholder Approval*, 18 W. RES. L. REV. 780, 799-801 (1967); see also Temkin, *When Does the "Fat Lady" Sing?: An Analysis of "Agreements in Principle" in Corporate Acquisitions*, 55 FORDHAM L. REV. 125, 148 (1986) ("courts should view the parties as having entered into a mutually binding agreement").

48. Compare *ConAgra, Inc. v. Cargill, Inc.*, 222 Neb. 136, 156, 382 N.W.2d 576, 588 (1986) (per curiam) ("[t]he [target] board was without statutory power to bind the corporation to the proposed [favored bidder] merger absent shareholder approval") with *Jewel Cos. v. Pay Less Drug Stores N.W., Inc.*, 741 F.2d 1555, 1560-61 (9th Cir. 1984) (target board has power to enter into binding performance promises prior to shareholder approval). Cf. *Smith v. Good Music Station, Inc.*, 36 Del. Ch. 262, 267, 129 A.2d 242, 245 (1957) (asset sale agreement could not have "any ultimate binding" effect prior to shareholder action); *Scott v. Stanton Heights Corp.*, 388 Pa. 628, 631, 131 A.2d 113, 116-17 (1957) (asset sale agreement binding pending shareholder action); *Masonic Temple, Inc. v. Ebert*, 199 S.C. 5, 12, 18 S.E.2d 584, 587 (1942) (agreement could not have any binding effect prior to shareholder action); *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768, 788-96 (Tex. Ct. App. 1987) (agreement in principle binding on target).

49. The Revised Model Business Corporation Act, for example, merely states that the merger agreement shall contain certain basic information and also "[m]ay set forth . . . other provisions relating to the merger," without placing any limitations on the substantive content of such provisions. MODEL BUSINESS CORP. ACT ANN. § 11.01(c)(2) (1985).

50. E.g., MODEL BUSINESS CORP. ACT ANN. §§ 11.03(i), 12.02(f) (1985); DEL. CODE ANN., tit. 8, § 271(b) (1988); CAL. CORP. CODE §§ 1105, 1201(f) (West 1977).

sions.⁵¹ In contrast, the Ninth Circuit interpreted a comparable provision in the California merger statute as validating exclusivity provisions.⁵² Specifically, the court found that the abandonment clause supported the validity of performance promises by recognizing that directors have broad discretion to make binding promises respecting their own conduct, and that the bidder possesses significant legal rights prior to shareholder approval.⁵³

Commentators also are divided as to the effect of abandonment statutes. One commentator focuses on the fact that abandonment provisions address only those transactions which already have received shareholder approval. In his view, the "necessary implication" of this limitation is that the merger agreement does not provide a source of rights and duties prior to shareholder approval, and hence cannot bind the board until that time.⁵⁴ Another commentator posits that abandonment provisions merely save directors from the need to seek shareholder approval of an abandonment following shareholder approval of the merger,⁵⁵ and thus neither enlarge nor diminish the parties' rights under the merger agreement.⁵⁶

In fact, the binding effect of exclusivity provisions has not depended on this or other questions of statutory interpretation.⁵⁷ Rather, courts have relied on equally debatable judicial interpretations of target directors' fiduciary duties. State corporate law has long recognized "the basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders."⁵⁸ Directors cannot contract away this duty; a contract that purports to relieve directors of their fiduciary duties simply is not binding.⁵⁹ The import of these

51. *Great Western Producers Co-Op. v. Great Western United Corp.*, 200 Colo. 180, 186 n.6, 613 P.2d 873, 878 n.6 (1980) (en banc).

52. *Jewel*, 741 F.2d at 1563.

53. *Id.* at 1563 n.10.

54. Buxbaum, *supra* note 4, at 1703.

55. Ward, *supra* note 47, at 792.

56. *Id.*

57. For a somewhat dated, but still useful, discussion of other statutory provisions that may indirectly cast light on the validity of exclusive merger agreements, see *id.* at 788-99.

58. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

59. See, e.g., *Jewel Cos. v. Pay Less Drug Stores N.W., Inc.*, 741 F.2d 1555, 1563 (9th Cir. 1984); *Great Western Producers Co-Op. v. Great Western United Corp.*, 200 Colo. 180, 186, 613 P.2d 873, 878 (1980) (en banc); *ConAgra, Inc. v. Cargill, Inc.*, 222 Neb. 136, 156-57, 382 N.W.2d 576, 587-88 (1986) (per curiam). This rule reflects the general proposition that contracts entered into by a fidu-

truisms for exclusivity provisions, however, remains a matter of considerable dispute.

In *Great Western Producers Cooperative v. Great Western United Corp.*,⁶⁰ the Colorado Supreme Court interpreted Delaware law as permitting a target board to renege on a performance promise.⁶¹ Section 271(a) of the Delaware corporation statute requires target directors to determine that a proposed asset sale is in the best interests of the corporation.⁶² The court found that this provision imposed on directors an ongoing responsibility to evaluate whether the terms and conditions of a transaction are in the shareholders' best interest. Thus, if business conditions change, as happened in *Great Western*, or if a third party makes a competing bid, as happened in *ConAgra, Inc. v. Cargill, Inc.*,⁶³ the target directors must reevaluate the initial offer and, exercising their independent good faith judgment, recommend the course of action they deem in the shareholders' best interest.⁶⁴ Because the directors may not validly agree to abrogate this function,⁶⁵ both courts held that a best efforts clause will not bind the target in the face of a higher competing offer or other changed circumstances that render the initial offer less attractive.⁶⁶

So interpreting a best efforts clause would be noncontro-

ciary which involve a breach of duty by the fiduciary are unenforceable as contrary to public policy. See RESTATEMENT (SECOND) OF CONTRACTS § 194 (1981).

60. 200 Colo. 180, 186-87, 613 P.2d 873, 878-89 (1980) (en banc).

61. *Id.* at 186-87, 613 P.2d at 878-79. *Accord* R-G Denver, Ltd. v. First City Holdings of Colo., Inc., 789 F.2d 1469, 1474-75 (10th Cir. 1986); *ConAgra*, 222 Neb. at 156-58, 382 N.W.2d at 587-88.

62. DEL. CODE ANN., tit. 8, § 271(a) (1988).

63. 222 Neb. 136, 382 N.W.2d 576 (1986) (per curiam).

64. *Id.* at 156, 382 N.W.2d at 588.

65. *Great Western*, 200 Colo. at 186, 613 P.2d at 878.

66. As the *Great Western* court stated: "The [best efforts] obligation . . . must be viewed in the context of unanticipated events and the exigencies of continuing business development and cannot be construed to require that such events and exigencies be ignored or overcome at all costs." *Id.* at 187, 613 P.2d at 878-79. As the best efforts clause at issue in *Great Western* did not specifically require the target's board to recommend the sale, the court did not need to decide whether such a clause could be binding. The court's imposition of a continuing duty to evaluate the fairness of the transaction's terms, however, may mandate that such clauses not be given effect. By definition, a contractual obligation to recommend the offer, irrespective of changed conditions, would conflict with the court's interpretation of a board's duties. In *ConAgra, Inc. v. Cargill, Inc.*, the Nebraska Supreme Court so interpreted *Great Western* in the face of just such a provision. 222 Neb. at 156, 382 N.W.2d at 588. See also R-G Denver, Ltd. v. First City Holdings of Colo., Inc., 789 F.2d 1469, 1474-75 (10th Cir. 1986). But see *infra* notes 206-11 and accompanying text (discussing the board's fiduciary duties to its shareholders).

versial if the agreement contains an appropriate fiduciary out. A fiduciary out may be simply a proviso stating that nothing contained in the merger agreement shall relieve the target board of its fiduciary duties to shareholders.⁶⁷ Alternatively, a fiduciary out may expressly retain the target board's right to solicit other offers or to negotiate with other bidders if the board's fiduciary duties so require.⁶⁸ The most potent version either relieves the target board of its obligation to recommend the initial offer to shareholders or permits the target to terminate the merger agreement if the board receives a higher offer.⁶⁹ Bidders typically resist inclusion of fiduciary outs (especially the latter variants) in merger agreements because they largely undermine the basic purpose of exclusivity provisions. Takeover practitioners are divided on whether target boards should insist on fiduciary outs.⁷⁰

In *ConAgra*, however, the court indicated that fiduciary outs are not necessary in order for a target board to freely renege on a best efforts clause.⁷¹ The best efforts clause at issue included a proviso that the clause did not "relieve either Board of Directors of their continuing duties to their respective shareholders."⁷² Rather than interpreting this fiduciary out as waiving the board's obligation to recommend shareholder approval if it decided the offer was no longer in the shareholders' interest,⁷³ the court merely noted that "it is clear that the parties recognized that there was a continuing fiduciary duty owed by each board of directors to its respective shareholders which could not be contracted away."⁷⁴ The court also endorsed the doctrine that target directors are subject to a duty to reevaluate the initial bid in light of changing circumstances.⁷⁵ By thus focusing on fiduciary rather than contractual duties, the *ConAgra* court evidently concluded that the directors' fiduciary duty

67. See, e.g., *ConAgra*, 222 Neb. at 146-47, 382 N.W.2d at 582; *Smith v. Van Gorkom*, 488 A.2d 858, 879 (Del. 1985) (en banc).

68. Nachbar, *supra* note 14, at 481.

69. See A. MICHEL & I. SHAKED, *supra* note 18, at 240; S. REED, *supra* note 14, at 755.

70. Compare A. MICHEL & I. SHAKED, *supra* note 18, at 240 with S. REED, *supra* note 14, at 756.

71. *ConAgra*, 222 Neb. at 155, 382 N.W.2d at 587.

72. *Id.* at 147, 382 N.W.2d at 582.

73. See *id.* at 166, 382 N.W.2d at 592 (White, J., dissenting); Kalish, *ConAgra, Inc. v. Cargill, Inc., An Interpretive Essay: A Target Corporation May, But Need Not, Agree That Its Directors Serve as Auctioneers for Its Shareholders*, 65 NEB. L. REV. 823, 824 (1986).

74. *ConAgra*, 222 Neb. at 155, 382 N.W.2d at 587.

75. See *id.* at 155-56, 382 N.W.2d at 588.

overrides the contractual best efforts obligation regardless of whether a fiduciary out is included in the agreement.⁷⁶

In *Jewel Cos. v. Pay Less Drug Stores Northwest, Inc.*,⁷⁷ the Ninth Circuit implicitly rejected the *Great Western/ConAgra* conclusion.⁷⁸ The Ninth Circuit treated performance promises as raising two distinct issues. The initial issue was whether directors can enter binding exclusivity provisions.⁷⁹ The court answered this question in the affirmative, holding that the target directors' fiduciary duties permitted the board "to decide that a proposed merger transaction is in the best interests of the shareholders at a given point in time" and to grant exclusivity provisions reflecting that determination.⁸⁰ The court's holding does not allow directors to contract away their fiduciary duties, as target directors must still act in the shareholders' best interest. In contrast to *Great Western* and *ConAgra*, however, the court will determine the board's compliance with their fiduciary duties (absent a fiduciary out) when the merger agreement is made, rather than when a competing bidder subsequently comes forward.⁸¹ The Ninth Circuit thus does not require directors to reevaluate the initial bid in light of changed circumstances.

The court found support for its holding in the basic structure of public corporations.⁸² Modern corporation statutes give target boards broad authority to determine whether to merge

76. See Note, *Merger Contracts*, *supra* note 3, at 752 n.192. But see Kalish, *supra* note 73, at 827-29 (noting that the ConAgra agreement conditioned directors' best efforts on their continuing duties to their shareholders).

77. 741 F.2d 1555 (9th Cir. 1984).

78. See also *Belden Corp. v. InterNorth, Inc.*, 90 Ill. App. 3d 547, 550, 413 N.E.2d 98, 102 (1980) (similarly rejecting such a conclusion that directors' fiduciary duty overrides a best efforts obligation regardless of the presence of a fiduciary out).

79. *Jewel*, 741 F.2d at 1561.

80. *Id.* at 1563. Accord *ConAgra, Inc. v. Cargill, Inc.*, 222 Neb. 136, 158-69, 382 N.W.2d 576, 589-95 (1986) (per curiam) (White, J., dissenting); see also *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 703 n.22 (2d Cir. 1980) ("[w]e know of no support for the . . . view . . . that the [target's] directors were required to reconsider the merger agreement that had been entered into and that they were contractually bound to recommend to shareholders"); *Scott v. Stanton Heights Corp.*, 388 Pa. 628, 631, 131 A.2d 113, 116-17 (1957) (board not liable to shareholder for adhering to asset sale agreement in face of subsequent higher offer); *Texaco, Inc. v. Pennzoil, Co.*, 729 S.W.2d 786, 808-09 (Tex. Ct. App. 1987) ("[o]nce the agreement was made, [the target] could not evade it, citing fiduciary duty, just because a higher offer came along").

81. *Jewel*, 741 F.2d at 1563.

82. See *id.* at 1560-64; see also *Belden*, 90 Ill. App. 3d at 550, 413 N.E.2d at 102.

the firm and to select a merger partner.⁸³ The initial decision to enter a negotiated merger transaction is thus reserved to the board's collective business judgment, shareholders having no statutory power to initiate merger negotiations.⁸⁴ The board also has sole power to negotiate the terms on which the merger will take place and to enter a definitive merger agreement embodying its decisions.⁸⁵ Shareholders have no statutory right to amend or veto specific provisions, their role typically being limited to approving or disapproving the merger agreement as a whole, with most statutes requiring approval by only a majority of the outstanding shares.⁸⁶

The Ninth Circuit used this statutory division of responsibility between directors and shareholders to both validate and limit the target board's discretionary power to enter a binding

83. See, e.g., CAL. CORP. CODE § 1101 (West 1977). If the target's board rejects the initial bidder, the merger process comes to a halt without shareholder involvement: A target's rejection does not require shareholder approval, the rejection decision being vested in the unilateral discretion of the board of directors. Johnson & Siegel, *supra* note 9, at 321-22.

84. See *Jewel Cos. v. Pay Less Drug Stores, N.W., Inc.*, 741 F.2d 1555, 1560 (9th Cir. 1984). In a few instances, shareholders have attempted to use SEC Rule 14a-8, 17 C.F.R. § 240.14a-8 (1990), as a means of inducing a fundamental corporate change such as a merger, sale of assets or liquidation. Although Rule 14a-8 requires that an issuer include in its proxy materials proposals made by eligible shareholders, the rule also permits the issuer to exclude those proposals that are "under the laws of the registrant's domicile, not a proper subject for action by security holders." 17 C.F.R. § 240.14a-8(c)(1) (1990). This provision was intended to prevent shareholders from infringing on matters committed by state law to the authority or discretion of the board of directors. Exchange Act Release No. 20091, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,417, at 86,204 (Aug. 16, 1984). However, the SEC has generally required inclusion of shareholder proposals calling for a merger or acquisition of the issuer, where the proposal is cast in the form of a recommendation to the issuer's board of directors, rather than in the form of a direction that the board seek out an acquirer. See, e.g., *Rorer Group, Inc.*, SEC No-Action Letter (Feb. 27, 1985) (LEXIS, FedSec library, NoAct file); *Richton International Corp.*, SEC No-Action Letter (Aug. 9, 1983) (LEXIS, FedSec library, NoAct file); *Texaco, Inc.*, SEC No-Action Letter (Jan. 27, 1983) (LEXIS, FedSec library, NoAct file); *Harnischfeger Corp.*, SEC No-Action Letter (Dec. 15, 1981) (LEXIS, FedSec library, NoAct file); *Two B System, Inc.*, SEC No-Action Letter [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,402, at 82,697 (Sept. 14, 1979) (LEXIS, FedSec library, NoAct file).

85. *Jewel*, 741 F.2d at 1561.

86. See, e.g., MODEL BUSINESS CORP. ACT ANN. §§ 11.03(e), 12.02(e) (1985); DEL. CODE ANN., tit. 8, §§ 251(c), 271 (1988). Some states require approval by higher percentages. See, e.g., ILL. ANN. STAT. ch. 32, §§ 11.20, 11.60 (West 1985) (asset sales must be approved by two-thirds of the outstanding shares entitled to vote, the corporation's articles of incorporation may vary from that figure, provided that the number of affirmative votes necessary for approval is not less than a majority of the outstanding shares entitled to vote).

merger agreement pending submission of the agreement to shareholders.⁸⁷ To assure that shareholders can exercise their role in the statutory scheme, the Ninth Circuit prohibited target directors from taking any action that deprives shareholders of their statutory right to ultimately decide the corporation's future — the board may only preserve the status quo until shareholders consider the offer.⁸⁸ Of course, preserving the status quo between the signing of the merger agreement and the shareholder vote is precisely the purpose of exclusivity provisions. Moreover, although exclusivity provisions prevent the board from reneging on the transaction in light of changed circumstances, they do not affect the shareholders' right to do so. Shareholders remain free to accept or reject the merger proposal presented by the board, respond to a merger proposal or a tender offer made by another firm subsequent to the board's execution of the exclusive merger agreement, or hold out for a better offer.⁸⁹ Accordingly, the Ninth Circuit specifically validated no-shop clauses by permitting the target board to "lawfully bind itself in a merger agreement to forbear from negotiating or accepting competing offers until the shareholders have had an opportunity to consider the initial proposal."⁹⁰ Best efforts clauses also should generally pass muster under *Jewel* because they, at most, require the directors to recommend shareholder approval.⁹¹

87. The *Jewel* court also relied on the fact that California's corporate code only requires shareholders to approve "the principal terms of a reorganization." *Jewel*, 741 F.2d at 1561 (citing CAL. CORP. CODE § 1201(a) (West Supp. 1984)). Accordingly, "[o]ther covenants in merger agreements that govern the conduct of the parties pending the shareholder vote are left within the province of the respective corporate boards." Johnson & Siegel, *supra* note 9, at 362.

88. See *Jewel*, 741 F.2d at 1562-64.

89. *Id.* at 1564; *Belden Corp. v. InterNorth, Inc.*, 90 Ill. App. 3d 547, 550-51, 413 N.E.2d 98, 102-03 (1980).

90. *Jewel Cos. v. Pay Less Drug Stores, N.W., Inc.*, 741 F.2d 1555, 1564 (9th Cir. 1984).

91. The Revised Model Business Corporation Act permits a board "in special circumstances" to forward a merger proposal to the shareholders without making a recommendation. See MODEL BUSINESS CORP. ACT ANN. § 11.03(b)(1) (1985). Neither the Act nor the commentary, however, addresses the question of whether the board must reserve the right to do so or has a continuing obligation to reassess the proposed transaction. In contrast, the Delaware Supreme Court has interpreted its merger statute, DEL. CODE ANN., tit. 8, § 251 (1988), as prohibiting a board from transmitting a merger proposal to its shareholders without making a recommendation or with a negative recommendation. *Smith v. Van Gorkom*, 488 A.2d 858, 888 (Del. 1985) (en banc). As a result, the board's only options would be to comply with the exclusive merger agreement by favorably recommending the transaction to the share-

The second issue of concern to the Ninth Circuit was the nature of the competing bidder's conduct: Even though an exclusivity provision is enforceable, not all competing bids constitute tortious interference with the contract. For an initial bidder to sustain a tortious interference with contract claim, it must show that the competing bidder induced the target board to breach the contract, or that a breach was imminent.⁹² Absent a fiduciary out, an enforceable exclusivity provision gives the favored bidder an unequivocal right to receive the performance promised by target management.⁹³ The favored bidder, however, does not have an unequivocal right to mandate merger consummation. Rather, it has only a mere expectancy in the merger.⁹⁴ A best efforts clause, for example, only entitles the favored bidder to have the merger presented and recommended to the target shareholders, who are under no obligation to approve the merger.⁹⁵ The tortious interference with contract doctrine thus protects the favored bidder only from competition that induces the target board to breach its promise.⁹⁶ Accordingly, despite an enforceable exclusivity provision, a competing bidder has substantial freedom to provide target shareholders with an alternative. If the competing bidder does no more than make a tender offer and identify the options open to target shareholders, the competing bidder's conduct will not give rise to liability.⁹⁷

holders or to rescind the merger agreement. But the court further indicated that rescinding an exclusive merger agreement might subject the target board to liability for breach of contract, implicitly suggesting that it would give performance promises binding effect. *Id.*

92. *Belden*, 90 Ill. App. 3d at 550, 413 N.E.2d at 102. Because the target was "firmly aligned" in opposition to the competing bid, the favored bidder's tort claims failed. *Id.* Professor Gilson suggests that *Jewel* should be interpreted as being consistent with *Belden*: "There is at least an implication that the mere making of a competing offer would not constitute tortious interference." R. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 837 n.14 (1986) (citing *Jewel*, 741 F.2d at 1564 n.13).

93. *Belden*, 90 Ill. App. 3d at 550, 413 N.E.2d at 102. In *Jewel* the Ninth Circuit remanded for further factual inquiry into whether the parties intended that the initial merger agreement be exclusive during the interim before shareholder approval was sought, as the record did not demonstrate whether the parties intended that the agreement obligate the target to abstain from negotiating or executing a competing merger agreement with another firm. 741 F.2d at 1564-69.

94. *Belden Corp. v. InterNorth, Inc.*, 90 Ill. App. 3d 547, 550-51, 413 N.E.2d 98, 102 (1980).

95. See *supra* note 89 and accompanying text.

96. *Belden*, 90 Ill. App. 3d at 551, 413 N.E.2d at 103.

97. *Id.* Compare *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768, 806 (Tex. Ct. App. 1987), in which Pennzoil received a judgment of approximately \$8.5

Although both *ConAgra* and *Great Western* purported to interpret Delaware law, it appears unlikely that the Delaware Supreme Court will adopt their interpretation. Although not the focus of the court's inquiry, the supreme court first touched on this question in *Smith v. Van Gorkom*.⁹⁸ In *Van Gorkom*, the court concluded that a fiduciary out contained in an exclusive merger agreement⁹⁹ "on its face cannot be construed as incorporating . . . either the right to accept a better offer or the right to distribute proprietary information to third parties."¹⁰⁰ This conclusion suggests that a contractual obligation to recommend the merger to shareholders binds the target board even if a higher bid emerges.

This implication is further supported by the court's discussion of the board's options with respect to the shareholder vote on the merger:

[T]he Board had but two options: (1) to proceed with the merger and the stockholder meeting, with the Board's recommendation of approval; or (2) to rescind its agreement with [the initial bidder], withdraw its approval of the merger, and notify the stockholders that the proposed shareholder meeting was cancelled.

...

But the second course of action would have clearly involved a substantial risk — that the Board would be faced with suit by [the initial bidder] for breach of contract.¹⁰¹

billion against Texaco for the latter's interference with Pennzoil's merger contract with Getty Oil, is perhaps best regarded as an aberration that does not disprove the *Belden* rule. Setting aside any criticisms that might be directed at the court's analysis, Texaco went beyond merely making a tender offer for Getty's shares. In particular, it entered into stock purchase contracts with major Getty shareholders who were parties to the agreement with Pennzoil and through them and other Getty representatives sought the support of Getty's board. *See id.* at 796-805.

98. 488 A.2d 858 (Del. 1985) (en banc). *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990), suggests that Delaware will follow neither line of authority, instead treating the validity of exclusive merger agreements under an entirely different methodology. *See infra* notes 327-33 and accompanying text.

The commentary on the *Van Gorkom* case is voluminous. Some useful samples include Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW 1437 (1985); Herzel & Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW 1187 (1986); Manning, *Life in the Boardroom after Van Gorkom*, 41 BUS. LAW 1 (1985).

99. The fiduciary out provided that the target directors "may have a competing fiduciary obligation to the shareholders under certain circumstances." *Van Gorkom*, 488 A.2d at 879.

100. *Id.*

101. *Id.* at 888. *See also* *City Capital Assoc. Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787, 798 n.15 (Del. Ch. 1988) (implying an obligation for board to recommend such a merger to shareholders). Professor Gilson, however,

By indicating that the breach of contract suit posed a "substantial risk," the court again appeared to suggest that the target board can legally bind itself to an exclusive merger agreement. Subsequent Delaware cases confirm that a target board can legally bind itself through an exclusive merger agreement if the board complies with its fiduciary duties when entering the agreement.¹⁰²

In sum, target directors considering a proposed exclusivity provision face considerable uncertainty. The divergent rules announced in *Great Western* and *Jewel* admittedly are relatively clear. Because so few jurisdictions have definitively addressed the question of target board power to enter binding exclusivity provisions, however, directors of firms incorporated in other states cannot know which line of authority will control their agreements. These directors thus must remain uncertain as to the validity of exclusivity provisions.

B. THE DUTY OF CARE APPROACH

Rather than focusing on a target board's authority to grant exclusivity provisions, some courts apparently assume that exclusivity provisions are valid if the board complied with its fiduciary duty of care when deciding to enter the exclusive merger agreement. Directors and officers owe a duty of care to their firm, which usually is formulated as requiring them to exercise that degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances.¹⁰³ The business judgment rule, however, shields directors and officers from personal liability in connection with business decisions by providing a presumption that the directors or officers 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.¹⁰⁴ In other words, even clear mistakes of judgment will not result in

rightly cautions that *Van Gorkom* is sufficiently ambiguous to render reliance on it a dubious proposition. See R. GILSON, *supra* note 92, at 836 n.11.

102. *Time*, 571 A.2d at 1140.

103. R. CLARK, *CORPORATE LAW* 123 (1986).

104. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271, 293 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980); *Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Auerbach v. Bennett*, 47 N.Y.2d 219, 225, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979); AMERICAN LAW INSTITUTE, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 4.01 (Tent. Draft No. 4 1985) [hereinafter *CORPO-*

personal liability.¹⁰⁵ Persons challenging the board's decision could traditionally rebut this presumption by showing that fraud, illegality, or self-dealing tainted the decision.¹⁰⁶

In *Smith v. Van Gorkom*,¹⁰⁷ the Delaware Supreme Court added another basis on which courts may set aside the business judgment rule. Specifically, the court ultimately denied the target directors the protections of the business judgment rule because they failed "to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders."¹⁰⁸ The central issue was the process by which the board approved the merger agreement and an accompanying lock-up.¹⁰⁹ Indeed, the court, in many respects, appeared to lay out a model target boards should follow when making corporate decisions of this magnitude.¹¹⁰

RATE GOVERNANCE: Draft No. 4]; see generally 3A FLETCHER CYC. CORP. § 1039-42 (perm. ed. 1986).

The Delaware Supreme Court has recognized, but not adopted, a distinction between the business judgment rule, which is said to shield corporate officers and directors from personal liability in connection with business decisions, and the business judgment doctrine, which shields the decision itself from review. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 n.10 (Del. 1986).

105. R. CLARK, *supra* note 103, at 123.

106. *Id.*

107. 488 A.2d 858 (Del. 1985) (en banc).

108. *Id.* at 873. In Delaware, the standard applicable to this determination is one of gross negligence, while in other jurisdictions a negligence standard may apply. Compare *id.* at 872 with *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 274-77 (2d Cir. 1986) (applying a duty of reasonable care). In addition, the Delaware Supreme Court found that the board had not fully and adequately disclosed all material facts to the shareholders. See *Van Gorkom*, 488 A.2d at 864.

109. The final agreement included a stock lock-up, a best efforts clause, and a no-shop covenant. The lock-up gave Pritzker an option, subsequently exercised, to purchase one million treasury shares of Trans Union stock (Trans Union had approximately 13.4 million shares outstanding) at \$38 per share — 75 cents over the then market price, but \$17 below the merger price. See *id.*, at 864 n.3, 883. The best efforts clause required Trans Union's board to recommend the merger to its shareholders, subject to a fiduciary out. See *id.* at 879.

110. See Herzel, Colling & Carlson, *supra* note 4, at 165; Herzel & Katz, *supra* note 98, at 1191-93; Manning, *supra* note 98, at 3. Strict adherence to the court's decision making model, however, may not be a prerequisite for the business judgment rule to be applicable. Throughout the opinion the court suggests that it continues to rely on the board as the primary decision maker in the corporate setting. E.g., *Van Gorkom*, 488 A.2d at 872 ("[t]he business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors"). Arguably, the basic thrust

The court strongly criticized the process by which Van Gorkom, the Chairman and CEO of the target corporation, conducted the merger negotiations with Pritzker, the initial bidder. At their initial meeting, Van Gorkom effectively asked Pritzker to purchase the corporation for \$55 per share, and told Pritzker how he could finance the transaction at that price.¹¹¹ Soon afterwards, Pritzker proposed a leveraged buyout at \$55 per share.¹¹² Van Gorkom's failure to haggle obviously concerned the court, especially given his fiduciary duty to obtain the best price possible.¹¹³ Equally troubling was Van Gorkom's failure to consult with the target directors and senior managers before effectively reaching an agreement with Pritzker.¹¹⁴ Additionally, the time constraints under which the board approved the merger and the perfunctory manner in which the matter was presented to and discussed by the board likely contributed to the court's impression that Van Gorkom railroaded the transaction through the board.¹¹⁵

The central issue, however, was the manner in which the

of the opinion is simply a requirement that the board provide some credible, contemporary evidence that it knew what it was doing.

111. *Van Gorkom*, 488 A.2d at 877.

112. *Id.* In buyout acquisitions, a closely held entity purchases substantially all the business and assets of a public corporation. To preclude future participation by non-participating shareholders in firm decisionmaking, the consideration used is typically cash or debt securities. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 3 (Tent. Draft No. 9, 1989) [hereinafter CORPORATE GOVERNANCE: Draft No. 9]. Most buyouts can also be classed as leveraged buyouts (LBOs), because they are typically financed with significant amounts of debt. In the management buyout (MBO) variant, members of the firm's incumbent management acquire a significant equity interest in the purchaser, which typically theretofore has not been an operating company or a subsidiary of one and whose other equity participants are usually specialized investment firms and institutional investors. See Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 732 (1985). In recent years, MBOs have become a common means of eliminating public ownership (going private) and of responding to a hostile takeover bid. See generally Williams, *Procedural Safeguards to Ensure Fairness in the Management Buyout: A Proposal*, 21 COLUM. J.L. & SOC. PROBS. 191 (1988).

113. *Van Gorkom*, 488 A.2d at 877.

114. During the negotiations with Pritzker, Van Gorkom only consulted with Peterson, the controller. Moreover, once senior management learned of the proposed transaction, they reacted negatively, a factor of some apparent import. Having evidence in the record of these types of internal disagreements obviously raised questions about the fairness of the transaction. *Id.* at 867-68.

115. See *id.* at 874-75. At a two-hour meeting, the board accepted the offer and that evening Van Gorkom executed the merger documents. The shareholders approved the merger, but disgruntled Trans Union shareholders soon brought a class action. *Id.*

board gathered information before making its decision. The duty of care requires directors to inform themselves of all material information reasonably available to them.¹¹⁶ In the court's view, the directors failed to fulfill this obligation. Among other things, the board twice failed to review the relevant documents, instead relying on brief oral presentations by Van Gorkom.¹¹⁷ This failure appears to have been critical. In the court's view, the board should have pressed Van Gorkom for the details on which he based his presentations; particularly emphasizing the basis for the acquisition price. Because the board relied on Van Gorkom, it failed to discover that Van Gorkom had suggested the \$55 price in the first place, and that he had based the price solely on a financing feasibility study.¹¹⁸ The court seemingly assumed that if the board had known these facts, it could not have reasonably believed that the price was fair without further evaluation.¹¹⁹

In response, the target directors claimed that they had satisfied their duty of care because the original merger agreement and subsequent amendments allowed the target to escape the merger agreement with Pritzker if a competing bidder made a higher offer. Specifically, the board claimed that it placed two conditions on its acceptance of the original merger agreement: "(1) that [the target] reserved the right to accept any better offer that was made during the market test period; and (2) that [the target] could share its proprietary information with any other potential bidders."¹²⁰ The board also noted that it later amended the merger agreement to allow active solicitation of competing bids and termination of the agreement with Pritzker if the board either consummated a merger or asset sale with a

116. *Id.* at 872-73. The American Law Institute has proposed a standard that only requires directors to be informed to the extent that they reasonably believe to be appropriate under the circumstances. This standard seemingly permits directors to make decisions on less than all reasonable available information, if they reasonably believe doing so is appropriate given the situation. Perkins, *The ALI Corporate Governance Project in Midstream*, 41 BUS. LAW. 1195, 1206 (1986).

117. *Smith v. Van Gorkom*, 488 A.2d 858, 877, 882-83 (Del. 1985) (en banc). While Delaware law provides that the directors are fully protected in relying in good faith on reports made by officers, DEL. CODE ANN., tit. 8, § 141(e) (1988), that protection was unavailable here. Van Gorkom's oral presentation was not a "report" because Van Gorkom himself was uninformed as to the details of the plan. *Id.* at 874-75.

118. *Id.* at 865. Rough calculations showed that a price of \$50 could be easily financed, while a price of \$60 would be difficult to finance. *Id.*

119. *Id.* at 875.

120. *Id.* at 869.

third party or entered a definitive acquisition agreement on more favorable terms within a specified time period.¹²¹ Finally, the board noted that it hired an investment banker to solicit other bids, but no firm offer materialized.¹²² In other words, the board argued that any deficiencies in its original decision were cured by a subsequent search for competing bids — the so-called market test.¹²³ The court rejected this rationale on several grounds. First, it concluded that the original merger agreement did not in fact permit the board to terminate the merger agreement if a higher offer emerged.¹²⁴ Second, in its view, the amendments, especially in light of the surrounding circumstances, did not permit a meaningful market test.¹²⁵ Finally, the court apparently believed that Van Gorkom's conduct during the market test period may have chilled the bidding process.¹²⁶

Van Gorkom, however, does not require a target board to shop the company among competing bidders to satisfy its duty of care.¹²⁷ Rather, the court seems to be saying that a target board must have some credible basis for determining that a proposed merger is in the best interest of shareholders. An unfettered market test is merely one means of satisfying the

121. *Id.* at 881-84.

122. In December 1980, the investment firm of Kravis, Kohlberg & Roberts (KKR) proposed, subject to obtaining necessary financing, a leveraged buyout of Trans Union for consideration equivalent to \$60 per share. KKR withdrew the offer before the board had an opportunity to consider it, purportedly because a key Trans Union manager declined to participate. *Id.* at 884-85. General Electric Credit Corporation also made an acquisition proposal, which was withdrawn because Pritzker refused to grant an extension of the planned Trans Union shareholders meeting. *Id.*

123. *Id.* at 878. Trans Union also argued that the reasonableness and fairness of Pritzker's \$55 per share price was confirmed by the market test. *Id.* The court, however, rejected this reasoning by ordering the trial court on remand to determine whether Trans Union's "intrinsic value" on September 20, 1980 exceeded \$55 per share and to award damages based on any resulting differential. *Id.* at 893.

124. *Id.* at 880.

125. *Id.* at 885. The board could no longer withdraw simply because a better offer was received. A requirement that Trans Union use its best efforts to mail a proxy statement relating to Pritzker's offer by early January effectively shortened the market test period. The announcement that Pritzker had exercised the lock-up option and had completed financing may have deterred other bidders. *See id.* at 881-84.

126. *Id.* at 884-85.

127. Of course, *Van Gorkom* was decided before the duty to auction control emerged in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). On the other hand, that duty has never been extended to *Van Gorkom*-type cases. *See infra* notes 285-333 and accompanying text.

board's duties. A determination of the firm's "intrinsic value," preferably in the form of a fairness opinion by an independent financial expert, is another.¹²⁸ A combination of both techniques is probably the safest approach, but the board should satisfy its duty of care even if it uses only the latter device.¹²⁹

In *Hanson Trust PLC v. ML SCM Acquisition, Inc.*,¹³⁰ the Second Circuit applied standards comparable to those announced in *Van Gorkom* to determine whether a target board's decision to grant an asset lock-up option was an informed one. Among other factors suggesting that the target board had failed to act with due care, the Second Circuit noted that the directors made their decision after a three-hour late night meeting.¹³¹ Quick action alone might not have condemned the decision, but the board also failed to use the time available properly.¹³² Specifically, the board failed to read or carefully review the agreements and offers¹³³ and to inquire into the basis of its financial adviser's opinion that the option prices were fair.¹³⁴ The court found that these failures placed the board's conduct outside of the usual rule that permits directors to rely on reports and

128. Although the Delaware Supreme Court expressly rejected a requirement that a written fairness opinion be obtained prior to a merger decision, *Van Gorkom*, 488 A.2d at 876, the Court's opinion clearly indicates reliance on internal valuations is a risky proposition at best. *See id.* at 875-78. As Professor Fischel aptly noted, "no firm considering a fundamental corporate change will do so without obtaining a fairness letter or similar documentation from outside consultants. Indeed, these outside consultants are the biggest winners after" *Van Gorkom*. Fischel, *supra* note 98, at 1453.

129. *Cf. In re TW Services, Inc. Shareholders Litig.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,179 n.8 (Del. Ch. Mar. 2, 1989) ("alternatives to an auction for collecting the information that directors need to make an informed choice may be appropriate"); *In re Amsted Indus., Inc. Litig.*, No. 8224, slip op. (Del. Ch. Aug. 24, 1988) (1988 Del. Ch. LEXIS 116) (alternatives to auction procedures acceptable), *aff'd*, 567 A.2d 1279 (Del. 1989).

130. 781 F.2d 264 (2d Cir. 1986) (applying New York law).

131. *Id.* at 275.

132. *Id.* Compare *Van Gorkom*, 488 A.2d at 875 with *Priddy v. Edelman*, 883 F.2d 438, 443 (6th Cir. 1989) (quick decision to accept one of two competing bids consistent with exercise of due care in light of "directors' rejection of the bidders' initial offers, close consultation with two carefully selected outside financial advisors, and insistence on further negotiations") and *Keyser v. Commonwealth Nat'l Fin. Corp.*, 644 F. Supp. 1130, 1147-49 (M.D. Pa. 1986) (in a later opinion in the same case, 675 F. Supp. 238 (M.D. Pa. 1987), the court indicated that new evidence created material issues of fact as to the board's due care) and *Thompson v. Enstar Corp.*, 509 A.2d 578, 581-82 (Del. Ch. 1984) (upholding lock-up despite quick action, in light of deadline imposed by bidder).

133. *Hanson Trust*, 781 F.2d at 275. The board relied solely on outside advisers. *Id.*

134. *Id.* at 275.

opinions of management and outside advisers.¹³⁵

The court found particularly troubling the board's failure to inquire into the adequacy of the option exercise price when considerable evidence existed that the optioned assets were worth far more than the exercise price.¹³⁶ In fact, the court concluded that if the favored bidder exercised the lock-up option and did not subsequently acquire the company, the target would be broken up for inadequate consideration.¹³⁷ The increase in the bid obtained by granting the lock-up¹³⁸ and the adequacy of the consideration to be paid for the underlying assets on exercise of the lock-up option¹³⁹ thus emerged as critical factors in determining the lock-up's validity.

The *Hanson Trust* court, however, recognized that because target boards often intend lock-ups to give the favored bidder "a bargain as an incentive to bid and an assured benefit should its bid fail,"¹⁴⁰ a bargain price alone does not indicate a breach

135. *Id.* at 275-76. *See also* Smith v. Van Gorkom, 488 A.2d 858, 875 (Del. 1985) (en banc) (board must review advisers' opinions). *But see* Buffalo Forge Co. v. Ogden Corp., 555 F. Supp. 892, 904 (W.D.N.Y.) ("[r]eliance upon the attorney's advice, even when unsound, is not a breach of fiduciary duty"), *aff'd*, 717 F.2d 757 (2d Cir.), *cert. denied*, 464 U.S. 1018 (1983); Whittaker Corp. v. Edgar, 535 F. Supp. 933, 951 (N.D. Ill. 1982) (same).

136. *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 275 (2d Cir. 1986). The board relied on a conclusory opinion by its investment banker that the price was within a fair range. Had the board probed the basis of that opinion it would have discovered that its adviser had failed to calculate a range of fairness. *Id.*

137. *Id.* at 283.

138. *Compare, e.g., id.* at 281-82 (lock-up invalidated, among other things, where board obtained only minimal price increase in return for granting option) and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986) (same) and *DMG, Inc. v. Aegis Corp.*, No. 7619, slip op. (Del. Ch. June 29, 1984), *reprinted in* 9 DEL. J. CORP. L. 437, 441-42 (1984) (lock-ups and cancellation fees granted solely in return for making of bid) with *Cottle v. Storer Communication, Inc.*, 849 F.2d 570, 576-77 (11th Cir. 1988) (asset lock-up upheld where substantial improvement in bid received in return for its grant) and *Thompson v. Enstar Corp.*, 509 A.2d 578, 583-84 (Del. Ch. 1984) (lock-up upheld even though mere making of bid was apparently the sole consideration for its grant).

139. *E.g., Hanson Trust*, 781 F.2d at 275-76, 278-80; *Buffalo Forge*, 717 F.2d at 759 (upholding lock-up where exercise price "exceeded the cost of the stock, its book value and its normal trading price," as well as the hostile offer price), *cert. denied*, 464 U.S. 1018 (1983); *Revlon*, 506 A.2d at 178 (assets' option price \$100 to \$175 million below fair value); *cf. Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 266 n.11 (2d Cir. 1984) ("[a]lthough a finding that the corporation received a fair price for shares transferred is not essential to establishing that a transaction is in the company's best interest, it is certainly relevant to the inquiry").

140. *Hanson Trust*, 781 F.2d at 276.

of the board's duty of care. Rather, the court prohibited only prices lower than necessary to entice a reluctant bidder.¹⁴¹ The court also required the directors to subject the proposal to substantial analysis to ensure that the price does not cross this critical line.¹⁴² At a minimum, the court apparently required a written fairness opinion by an independent financial adviser and board minutes reflecting extensive inquiry into the basis for that opinion.¹⁴³

A final, crucial factor in the court's decision was that the board essentially rubber-stamped management's proposals even though management would have an equity interest in the surviving entity and thus had an obvious conflict of interest with the shareholders.¹⁴⁴ On the one hand, managers, as agents of the shareholders, must seek the best possible price for the corporation. On the other hand, managers who will receive an equity interest in the surviving entity also are acting as purchasers and thus have an incentive to sell the corporation for the lowest price possible.¹⁴⁵ The lock-up option, which effectively precluded further bidding by potential acquirers and coerced shareholders into accepting the transaction, compounded this conflict of interest.¹⁴⁶ The temptation to pay an unfairly low price must surely be exacerbated when competing offers are effectively foreclosed.¹⁴⁷

141. *Id.*

142. *Id.*

143. *See id.* at 275-77.

144. *Hanson Trust*, 781 F.2d at 277. Compare *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 886 (6th Cir. 1986) (lock-up invalidated where board "rubber stamped" agreement with MBO group) with *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757, 759 (2d Cir.) (lock-up upheld where hard "arms-length" negotiations conducted with unaffiliated bidder), *cert. denied*, 464 U.S. 1018 (1983) and *Hastings-Murtagh v. Texas Air Corp.*, 649 F. Supp. 479, 485 (S.D. Fla. 1986) (same).

145. *See Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 284 (Oakes, J., concurring); Williams, *supra* note 112, at 192 n.4 (quoting Longstreth, Remarks to the International Bar Association (Toronto, Oct. 6, 1983) (Management Buyouts: Are Public Shareholders Getting a Fair Deal?)).

146. *Hanson Trust*, 781 F.2d at 277, 281-83. The bid-preclusive and coercive effects of lock-ups are discussed *infra* notes 212-15 and accompanying text.

147. To eliminate a comparable conflict of interest, trust law largely prohibits the trustee from selling trust assets to himself. The Restatement of Trusts applies this prohibition to virtually all sales to the trustee, regardless of whether, among other things, the sale was done by auction, the trustee profits from the transaction or the trustee paid fair consideration for the assets. RESTATEMENT OF TRUSTS (SECOND) § 170 comment b (1959). *See* 2A A. SCOTT & W. FRATCHER, THE LAW OF TRUSTS §§ 170.1 -11 (4th ed. 1988). Only in a few circumstances, such as where the sale is effected subject to court approval or pursuant to the express terms of the trust instrument, is a trustee permitted

In summary, *Van Gorkom* and *Hanson Trust* assume that target boards have the power to grant exclusivity provisions and lock-ups. They stress that target boards have a duty to use due care when deciding to grant exclusivity provisions and lock-ups. Courts following *Van Gorkom* and *Hanson Trust* will closely scrutinize the process through which the board reached its decision to grant the exclusivity provision or lock-up, and may invalidate the provision, impose personal liability on the directors, or enjoin the transaction if the directors failed to jump through the proper hoops.¹⁴⁸

II. DEFINING THE PROBLEM

As Part I demonstrates, courts reviewing exclusivity provisions and lock-ups traditionally have used one of two distinct inquiries: (1) does the target board have the power to enter into binding promises before shareholder action; or (2) did the board make an informed decision when agreeing to the exclusivity provision or lock-up. Both inquiries purportedly arise out of management's fiduciary obligations. Both ask important questions. But neither asks the critical question.

At the heart of management's fiduciary duties is an obligation to make decisions based on their unbiased, independent judgment as to the best interests of the firm's shareholders.¹⁴⁹ If directors have made an objective, reasonably informed decision, they have done all that their duties require. Thus, the critical question is whether the board's decision was objective. In other words, is there a substantial risk that personal inter-

to purchase trust assets. *Id.* at §§ 170.7 -9. Corporate law's failure to adopt a comparable prohibition appears justified in light of the strong evidence that MBOs can benefit target shareholders and the economy. See DeAngelo, DeAngelo & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J.L. & ECON. 367, 400-01 (1984); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 723-31 (1982); Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 816-32 (1987).

148. Since *Van Gorkom*, many states have adopted new director liability statutes, providing that directors will not be monetarily liable unless they commit a breach of the duty of loyalty; in other words, if an appropriate amendment to the firm's charter is made, monetary liability may not be imposed on directors who violate the duty of care. *E.g.*, DEL. CODE ANN., tit. 8, §§ 102(b)(7), 145 (1988). See generally Steinberg, *The Evisceration of the Duty of Care*, 42 SW. L.J. 919 (1988) (examining recent director liability legislation); Note, *Corporate Directors — An Endangered Species? A More Reasonable Standard for Director and Officer Liability in Illinois*, 1987 U. ILL. L. REV. 495 (examining Illinois legislation).

149. See *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

ests conflicting with those of the shareholders affected the board's decision? This Part argues that a potential conflict of interest exists in all negotiated acquisitions and that competitive bidding — an auction of corporate control — is the best available constraint on self-interested behavior by target management.

A. COMPETITIVE BIDDING AND MANAGEMENT CONFLICTS OF INTEREST

During the early 1980s there was a voluminous debate over the shareholder and social wealth effects of competitive bidding in hostile takeover battles.¹⁵⁰ Although that debate still rages in some quarters, this Article takes an essentially agnostic position with respect to it. Indeed, one can argue that the side of the debate on which one comes down largely remains a matter of intuition. There simply is no good empirical data as to the net economic effects of competitive bidding.¹⁵¹ Instead, this Article focuses on the role of competitive bidding in constraining self-interested behavior by target managers in the negotiated acquisition setting.

Inherent in all corporate acquisitions is a potential conflict between the interests of target managers and the interests of shareholders.¹⁵² This tension is perhaps most obvious in hostile

150. See, e.g., Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23, 27-30 (1982) [hereinafter Bebchuk, *Reply and Extension*]; Easterbrook & Fischel, *Proper Role*, *supra* note 6, at 1165-82; Easterbrook & Fischel, *Auctions*, *supra* note 6, at 7-9; Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982); Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987); Oesterle, *Target Managers as Negotiating Agents for Target Shareholders: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53 (1985).

151. See Bebchuk, *Reply and Extension*, *supra* note 150, at 49; Easterbrook & Fischel, *Auctions*, *supra* note 6, at 6, 21; Haddock, Macey & McChesney, *supra* note 150, at 724, 741; cf. Milgrom, *The Economics of Competitive Bidding: A Selective Survey*, in SOCIAL GOALS AND SOCIAL ORGANIZATIONS 261, 287 (L. Hurwicz, D. Schmeidler & H. Sonnenschein eds. 1985) (current economic theory offers relatively little insight into the general question of when auctions are the best means of selling any asset). For a useful recent summary of the theoretical and empirical literature on control auctions in corporate takeovers, as well as a cogent analysis of when such auctions are desirable, see Macey, *Auction Theory, MBOs and Property Rights in Corporate Assets*, 25 WAKE FOREST L. REV. 85 (1990).

152. Corporate acquisitions are a classic example of what economists refer to as "final period problems." R. GILSON, *supra* note 91, at 579. Where parties (such as management and shareholders) expect to have repeated transactions,

takeovers. If the bidder is successful, many target directors and officers will almost certainly lose their positions.¹⁵³ On the other hand, if incumbent management defeats the bidder, target directors and officers will retain their positions, but target shareholders will lose a substantial premium for their shares.¹⁵⁴ Any action by management in a hostile takeover situation, except pure passivity, is thus tainted by the specter of self-interest.¹⁵⁵

A similar conflict of interest also arises in negotiated acquisitions. Because approval by the target board is a necessary prerequisite to most acquisition methods, the modern corporate statutory scheme gives management considerable power in negotiated acquisitions. To purchase the board's cooperation, the bidder may offer management side payments such as equity in the surviving entity, employment contracts, substantial severance payments, continuation of existing fringe benefits, or

the risk of self-dealing by one party is constrained by the threat that the other party will punish the cheating party in future transactions. In a final period transaction, this constraint disappears. Because the final period transaction is the last in the series, the threat of future punishment disappears. *Id.*

In addition, a variety of other extra-judicial forces (such as the markets for corporate control and managerial services) somewhat constrain management's ability to structure ordinary corporate transactions so as to benefit itself. See generally Easterbrook & Fischel, *Proper Role*, *supra* note 6, at 1196-97 (discussing the various market forces and incentives that ensure management will generally act in the best interests of shareholders); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 836-40 (1981) (noting the constraints the corporate structure puts on management discretion). In many corporate acquisitions, however, target management is no longer subject to market discipline because the target by definition is no longer operating in the market as an independent agency. As a result, management is no longer subject to either shareholder or market penalties for self-dealing. R. GILSON, *supra* note 91, at 579.

153. See Walking & Long, *Agency Theory, Managerial Welfare, and Takeover Bid Resistance*, 15 RAND J. ECON. 54, 54-55 (1984).

154. See Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733, 1739-43 (1981); Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 281-85 (1984); Jarrell, Brickley & Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49, 54-55 (1988); Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 10-11 (1983); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 106-09 (1979); Margotta & Marston, *Long-Term Results of Defeated Tender Offers (Working Paper 87-29 1987)*, reprinted in CORPORATE TAKEOVERS REVISITED: POLICY IMPLICATIONS OF RECENT RESEARCH 1 (Brookings Institution Forum Sept. 22, 1987).

155. The classic statement of this conflict is Easterbrook & Fischel, *Proper Role*, *supra* note 6.

other compensation arrangements.¹⁵⁶ These side payments rarely are large enough to materially affect the price the bidder could otherwise pay target shareholders. A more likely scenario is that side payments will affect the target board's decision making — insiders promised side payments may agree to an acquisition price lower than they could obtain from hard bargaining or open bidding.¹⁵⁷

Even when the target's management is not consciously seeking side payments, the bidder's offer to retain management and maintain the corporate identity may create a conflict of interest.

There may be at work [in negotiated acquisitions] a force more subtle than a desire to maintain a title or office in order to assure continued salary or perquisites. Many people commit a huge portion of their lives to a single large-scale business organization. They derive their identity in part from that organization and feel that they contribute to the identity of the firm. The mission of the firm is not seen by those involved with it as wholly economic, nor the continued existence of its distinctive identity as a matter of indifference.¹⁵⁸

156. *E.g.*, *Samjens Partners I v. Burlington Indus., Inc.*, 663 F. Supp. 614, 618 (S.D.N.Y. 1987) (white knight offered target management equity stake); *Singer v. Magnavox Co.*, 380 A.2d 969, 974 (Del. 1977) (target directors offered employment contracts); *Repairman's Service Corp. v. National Intergroup, Inc.*, No. 7811, slip op. (Del. Ch. March 15, 1985), *reprinted in* 10 DEL. J. CORP. L. 902, 907 (1985) (plaintiff claimed target managers sought "preferences for themselves" in surviving entity); *Gilbert v. El Paso Co.*, 490 A.2d 1050, 1054 (Del. Ch. 1984) (plaintiff alleged tender offeror modified bid to benefit target managers), *aff'd*, 575 A.2d 1131 (Del. 1990). *See generally* Gilson, *Structural Approach to Corporations*, *supra* note 152, at 825-26 (management offered incentives to ensure board cooperation); *Johnson & Siegel*, *supra* note 9, at 325 (same); *Macey*, *supra* note 151, at 114 (same); *Walking & Long*, *supra* note 153, at 67 (incumbent managers more likely to be retained in an uncontested takeover). There is some evidence, however, that target managers act in the shareholders' best interests in negotiating a merger; in particular, target managers appear to bargain quite firmly with offerors, extracting most of the gains from an acquisition for the shareholders. *See Haddock, Macey & McChesney*, *supra* note 150, at 738.

157. *E.g.*, *Pupecki v. James Madison Corp.*, 376 Mass. 212, 215, 382 N.E.2d 1030, 1033 (1978) (plaintiff claimed that consideration for sale of assets was reduced due to side payments to controlling shareholder); *Barr v. Wackman*, 36 N.Y.2d 371, 376, 329 N.E.2d 180, 184, 368 N.Y.S.2d 497, 500 (1975) (plaintiff claimed target directors agreed to low acquisition price in exchange for employment contracts); *see Oesterle*, *supra* note 1, at 131.

An argument can perhaps be made that some side payments to management are justified in light of its investment in firm specific human capital. *See Coffee, Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 105 (1986); *Haddock, Macey & McChesney*, *supra* note 150, at 712-17. This Article assumes, however, that side payments conflict with shareholder interests and management's fiduciary duties.

158. *Paramount Communications, Inc. v. Time, Inc.*, [1989 Transfer Binder]

Although such motivations are understandable, they also may result in management decisions contrary to the shareholders' economic interest.

Competing offers and the threat of competing offers provide an effective check on conflicts of interest in negotiated acquisitions.¹⁵⁹ True, the competing bidder cannot structure its acquisition as a merger or asset sale if it is unable to persuade target management to change sides. The intervenor, however, has a formidable alternative: the tender offer. The cash tender offer emerged in the 1960s as a potent weapon in the hostile bidder's arsenal,¹⁶⁰ because it eliminates the need for target board cooperation by permitting the bidder to buy a controlling share block directly from the stockholders.¹⁶¹ Accordingly, where side payments persuade the target board to accept a low initial offer, a second bidder may — and often does — succeed by offering shareholders a higher-priced alternative. Indeed, in the rare case when side payments affect the initial bidder's ability to raise its offer, the second bidder is almost certain to prevail.

B. ALTERNATIVE CONSTRAINTS ON MANAGEMENT'S CONFLICT OF INTEREST

To the extent that exclusivity provisions and lock-ups impede competitive bidding, they shield target management and favored bidders from the risks posed by competing bidders.¹⁶²

Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,268-69 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989). For a fascinating popular account of the role corporate "culture" played in the *Time* case, see Bruck, *The World of Business: Deal of the Year*, NEW YORKER, Jan. 8, 1990, at 66-89.

159. See Bebchuk, *Reply and Extension*, *supra* note 150, at 25 n.8; Gilson, *Structural Approach to Corporations*, *supra* note 152, at 847 n.103, 850; Johnson & Siegel, *supra* note 9, at 407.

160. Bainbridge, *State Takeover and Tender Offer Regulations Post-MITE: The Maryland, Ohio and Pennsylvania Attempts*, 90 DICK. L. REV. 731, 735 (1986).

161. *Id.* The tender offer's increased popularity thus in large part reflected the significant advantages it possessed over its principal alternative — a merger proposal. *Id.* Proxy contests, like tender offers, permit a bidder to end-run management, but suffer from a number of other drawbacks that rendered them "the most expensive, the most uncertain, and the least used of the various techniques" of acquiring corporate control. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 114 (1965).

162. The efficiency of competitive bidding in the market for corporate control has been the subject of some debate. Compare Gordon & Kornhauser, *Takeover Defensive Tactics: A Comment on Two Models*, 96 YALE L.J. 295, 310 (1986) (concluding market control is efficient) with Bradley & Rosenzweig, *Defensive Stock Repurchases and the Appraisal Remedy*, 96 YALE L.J. 322, 332

This effect might be unobjectionable if other legal or extrajudicial mechanisms adequately constrained management's conflict of interest. Unfortunately, the commonly cited alternatives — supervision by independent directors, shareholder approval, the threat of post-merger acquisitions, and judicial review — do not match the effectiveness of competing bids.¹⁶³

1. Approval by Independent Directors

Experience and common sense indicate that independent directors do not adequately constrain self-interested behavior by a target board.¹⁶⁴ A striking example of this failure is the

(1986) (concluding market control is inefficient). The argument here, however, is not that competitive bidding is a perfect solution to management's conflict of interest, but rather that it is the best available option.

163. Another factor, which has only recently begun to receive attention, is the risk that persistent overpayment in acquisitions is likely to render the bidder an attractive target by devaluing its stock price. See Mitchell & Lehn, *Do Bad Bidders Become Good Targets?* 29 (Aug. 25, 1988) (unpublished study by SEC economists; on file with *Minnesota Law Review*). Rational bidders would thus refuse to pay excessive side payments, instead threatening to eschew a negotiated takeover in favor of a purely hostile bid, if side payments would result in overpayment for the target.

164. Many courts and commentators have urged that takeover decisions be made by independent directors in order to neutralize the insiders' conflict of interest. *E.g.*, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (target firm's efforts to prove its directors acted reasonably and in good faith in adopting takeover defenses are "materially enhanced" if the actions are approved by "a board comprised of a majority of outside independent directors"); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n.7 (Del. 1983) (where parent corporation breached its fiduciary duties to minority shareholders of a subsidiary in a freezeout merger, the court suggested: "the result here could have been entirely different if [the target] had appointed an independent negotiating committee of its outside directors to deal with [the parent] at arm's length"); cf. *Johnson & Siegel*, *supra* note 9, at 378-84 (decisions relating to exclusive merger agreements be vested in the board's independent directors, although recognizing that additional constraints are necessary); Note, *Down But Not Out — The Lock-Up Option Still Has Legal Punch When Properly Used*, 43 WASH. & LEE L. REV. 1125, 1157-58 (1986) (same). For purposes of this article, it suffices to define an "independent" director as a member of the board of directors who is not otherwise employed by or affiliated with the corporation. There is a vast literature on the efficacy of independent directors in generally constraining managerial misconduct. A brief sampling follows: R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* (1976); AMERICAN LAW INSTITUTE, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATION* § 3.03-.04, at 83-84 (Tent. Draft No. 2 1984); American Bar Ass'n Comm. on Corp. Laws, *Corporate Director's Guidebook*, 33 BUS. LAW. 1595 (1978); Brudney, *The Independent Director — Heavenly City or Potemkin Village*, 95 HARV. L. REV. 597 (1982); Haft, *Business Decision by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1 (1981); Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW 1799 (1976); The Business Roundtable, *The Role and Composition*

use of "Special Litigation Committees" consisting of independent directors to determine whether corporations should support shareholder derivative litigation against their officers or directors. In theory, these committees provide unbiased recommendations as to whether litigation should proceed. A 1982 study, however, discloses that "although there have been more than a score of special litigation committee cases . . . , in all but one the committee concluded that the suit was not in the corporation's best interest."¹⁶⁵

This result is not particularly surprising. Even when independent directors are not overtly biased towards incumbent insiders, structural bias may affect their judgment. Outside directors tend to be corporate officers or retirees who likely will share the same views and values as the insiders.¹⁶⁶ A sense of "there but for the grace of God go I" is perhaps the likely response to litigation against fellow directors.¹⁶⁷

The same sort of bias may affect independent director's decisions in negotiated mergers. According to one survey, over fifty percent of responding companies believed they were possible takeover targets, forty-five percent had been the subject of takeover rumors, and thirty-six percent experienced unusual or unexplained trading activity.¹⁶⁸ When a nominally independent director's principal occupation is serving as an officer of another corporation, the "there but for the grace of God go I" syndrome again rears its head.¹⁶⁹ Despite being an outsider, fears for his or her own firm must often render an outside director sympathetic to insiders' job security concerns.

of the Board of Directors of the Large Publicly Owned Corporation, 33 BUS. LAW 2083 (1978).

165. Cox, *Searching for the Corporation's Voice in Derivative Litigation*, 1982 DUKE L.J. 959, 963.

166. See *Joy v. North*, 692 F.2d 880, 888 (2d Cir. 1982), *cert. denied sub. nom.* *Citytrust v. Joy*, 460 U.S. 1051 (1983); Cox, *supra* note 165, at 960-61; Cox & Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 99-108 (1985); Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 NW. U.L. REV. 96, 111-13 (1980). But see Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385, 425-30 (discussing limits on the structural bias argument in the takeover context); Johnson & Siegel, *supra* note 9, at 382-84 (arguing that structural bias is not a significant problem in the acquisition context).

167. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (Del. 1981).

168. S. REP. NO. 265, 100th Cong., 1st Sess. 79 (1987) (additional views of Sens. Sasser, Sanford & Chaffee).

169. Cf. Gilson, *supra* note 152, at 881 n.220 (outside directors "may well not be attitudinally independent").

The argument is not that independent directors have no role to play in policing management conduct. Delegating decisions to disinterested board members at least avoids an appearance of impropriety and may in fact prevent abuses. The point is simply that independence alone does not justify significant judicial deference to board decisions. As Judge Posner nicely summarized the problem in a related context:

When managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the takeover attempt succeeds, they have a clear conflict of interest, and it is not cured by vesting the power of decision in a board of directors in which insiders are a minority. . . . No one likes to be fired, whether he is just a director or also an officer. The so-called outsiders moreover are often friends of the insiders. And since they spend only part of their time on the affairs of the corporation, their knowledge of those affairs is much less than that of the insiders, to whom they are likely therefore to defer.¹⁷⁰

Although many courts still purport to give somewhat greater deference to merger decisions when a majority of the board is independent,¹⁷¹ especially when the board is advised by independent counsel and investment bankers,¹⁷² in fact most courts follow Posner and carefully scrutinize the board's conduct to ensure that it did not merely rubber stamp incumbent management's decision.¹⁷³

Interestingly, judicial deference to independent directors arguably has been greatest in freezeout mergers between parent and subsidiary corporations.¹⁷⁴ Because a controlling shareholder who has proposed a freezeout merger need not sell its

170. *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987).

171. *See, e.g., Whittaker Corp. v. Edgar*, 535 F. Supp. 933, 951 (N.D. Ill. 1982); *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 780 (Del. Ch. 1988); *Freedman v. Restaurant Assoc., Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502, at 97,219 (Del. Ch. 1987); *Thompson v. Enstar Corp.*, 509 A.2d 578, 581 (Del. Ch. 1984).

172. *See Herzog, Colling & Carlson, supra* note 4, at 160-62. *But cf. Cottle v. Storer Communication, Inc.*, 849 F.2d 570, 577-78 (11th Cir. 1988) (not abuse of discretion for board to rely on financial adviser having preexisting relationship with management).

173. *See, e.g., Edelman v. Fruehauf Corp.*, 798 F.2d 882, 886 (6th Cir. 1986); *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 277 (2d Cir. 1986); *see also Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176 n.3 (Del. 1986) (board is not presumed to be independent, because of 14 directors, six held senior management positions, two others held significant blocks of stock, and six others had previously carried on business with the corporation); *Smith v. Van Gorkom*, 488 A.2d 844, 872, 874-75 (Del. 1985) (*en banc*) (board's conduct equally scrutinized).

174. *See supra* note 164.

shares to a competing bidder or otherwise make alternative transactions available to minority shareholders,¹⁷⁵ competing bids would be futile. In this case, independent directors are the only available extrajudicial means of neutralizing the controlling shareholder's conflict of interest.¹⁷⁶ Where competitive bidding is a viable option, however, it provides a significantly more effective constraint on management's conflict of interest.

2. Approval by Shareholders

Absent a competing bid, the requirement that shareholders approve a proposed negotiated acquisition is particularly unlikely to constrain management's conduct. Rational shareholders will expend the effort to make informed voting decisions only if the expected benefits of doing so outweigh the costs.¹⁷⁷ Given the length and complexity of merger proxy statements, the opportunity cost entailed in reading a proxy statement before voting is quite high and very apparent. In contrast, shareholders probably do not expect the proxy statement to disclose grounds for opposing the proposed transaction.¹⁷⁸ Frequently there are no grounds. Even when grounds for opposing the acquisition exist, shareholders will have difficulty discerning them from the proxy statement. Accordingly, shareholders presumably assign a relatively low value to the expected benefits of carefully considering the proxy material. Shareholders are thus rationally apathetic — the expected benefits of carefully reviewing the proxy material simply do not outweigh the investment of time and effort necessary to do so.¹⁷⁹ As a result, shareholders are likely to approve board-supported transactions even though the transaction furthers management interest rather than shareholder interest.¹⁸⁰

The situation, however, changes rather dramatically when

175. See *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1987).

176. See CORPORATE GOVERNANCE: Draft No. 9, *supra* note 112, at 5.

177. See R. CLARK, *supra* note 103, at 391.

178. *Id.*

179. See *id.* at 390-92; Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 66-67 (1988). The problem is compounded by the likelihood that a substantial number of shareholders will attempt to free-ride on the efforts of a few informed shareholders. See R. CLARK, *supra* note 103, at 392-93.

180. See R. CLARK, *supra* note 103, at 392-93; see also Freund & Easton, *supra* note 26, at 1712; Gabaldon, *supra* note 26, at 1233; Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 261 (1962); cf. Gilson, *supra* note 152, at 822-27 (shareholders routinely approve takeover defenses).

a competing bid is made. Setting aside complicating issues such as differing forms of consideration, shareholders now must make a rather simple decision: Should they accept the higher or lower priced bid? Accordingly, shareholder apathy should largely dissipate in competitive bidding situations.¹⁸¹ The effectiveness of shareholder approval requirements in monitoring management's negotiation of an acquisition proposal thus depends on the viability of competitive bidding.

3. Post-Merger Acquisitions

Theoretically, a competing bidder shut out of an initial acquisition by an exclusivity provision or lock-up could acquire the combined entity. The threat of a post-merger takeover could conceivably constrain the target board's self-interested behavior in the initial acquisition. This threat, however, is often *de minimis*. The greater cost of acquiring the combined firm may often prove beyond the competing bidder's means.¹⁸² Moreover, the combined firm can use the full array of takeover defenses and applicable state takeover laws to fend off a hostile bid. Thus, the theoretical availability of post-merger bidding opportunities is unlikely to restrain the target board's conflict of interest in the initial merger.

4. Judicial Review

Judicial review of exclusivity provisions and lock-ups has failed to effectively constrain self-interested behavior by target

181. Cf. Ruback, *supra* note 7, at 147 (in all studied cases, target shareholders accepted the most valuable offer); Nachbar, *supra* note 14, at 482 (shareholders likely to accept best offer). The growing importance of takeover arbitrageurs may somewhat offset the problem of rational shareholder apathy even in the absence of a competing bid. See Note, *Merger Contracts*, *supra* note 3, at 760. Professors Johnson and Siegel likewise argue that shareholder apathy is also countered by the heavy concentration of shareholdings in the hands of institutional investors. Johnson & Siegel, *supra* note 9, at 401 n.332. There is strong evidence, however, that the principal focus of institutional investors is on short-term returns. See Lipton, *supra* note 179, at 7-8. Accordingly, it would be surprising if either arbitrageurs, who by definition are short-term speculators, or institutional investors would vote against an acquisition proposal (typically paying a substantial premium over their purchase costs) unless they expected a competing bid to emerge.

182. Indeed, the combined firm may be sufficiently large as to preclude any acquisition effort. Although "recent history has shown that huge acquisitions can be done", *Paramount Communications, Inc. v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,264 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989), very large transactions probably will remain rare.

boards on two critical fronts. First, there is considerable uncertainty as to the applicability and content of the current legal regimes. Second, the courts are simply not asking the right questions.

a. *Judicial Uncertainty and its Costs*

As we have seen, target directors evaluating exclusivity provisions and lock-ups cannot know whether a reviewing court will focus on the directors' powers, the steps they took to gather the information on which they based their decision, or both. Equally critical are the ambiguities in each approach. As to the former approach, uncertainty results from the rarity of decisions and the lack of uniformity among jurisdictions that have addressed this issue. As to the latter approach, uncertainty is inherent in the very nature of the inquiry.

Neither *Van Gorkom* nor *Hanson Trust*, which applied the duty of care approach, prohibited the use of exclusivity provisions and lock-ups. The *Hanson Trust* court, however, did explicitly indicate that the duty of care requires compliance with certain procedural safeguards, so-called "prophylactic steps."¹⁸³ The benefits that flow from this emphasis on proper procedure, however, are not free. Outside legal and financial experts are more than willing to guide firms over procedural hurdles and to provide documentation necessary to create the proper record — in return for substantial fees. As Professor Fischel wryly observed with respect to *Van Gorkom*: "I wish someone would pay me several hundred thousand dollars to state that \$55 is greater than \$35."¹⁸⁴

Forcing target boards to jump through specified hoops would be less objectionable if doing so provided some assurances that the transaction would then pass muster. Unfortunately, neither *Van Gorkom* nor *Hanson Trust* provide substantial guidance to directors currently faced with merger decisions. Directors can answer most of the questions these two cases raise only with hindsight. Moreover, these questions re-

183. The *Hanson Trust* court specifically endorsed the "steps that were previously identified as constituting due care" in *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 384 (2d Cir. 1980): "the directors 'armed' their bankers with financial questions to evaluate; they requested balance sheets; they adjourned deliberations for one week to consider the requisitioned advice; and they conditioned approval of the deal on the securing of a fairness opinion from their bankers." *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 275 (2d Cir. 1986).

184. Fischel, *supra* note 98, at 1453.

quire courts to evaluate factors (such as valuation procedures) that "are precisely the types of issues that [they] are ill-equipped to explore and whose judicial exploration the business judgment rule is designed to preclude."¹⁸⁵ Thus, they threaten to significantly increase the transaction costs associated with corporate acquisitions, thereby decreasing shareholder returns.¹⁸⁶ These questions also essentially mandate judicial second-guessing of business decisions and are therefore likely to result in greater uncertainty as to exclusivity provision and lock-up validity.¹⁸⁷

The present uncertainty as to the validity of exclusivity provisions and lock-ups produces important social costs. If uncertainty causes parties to not enter into exclusivity provisions or lock-ups when the provisions, in fact, would benefit shareholders, socially desirable behavior is deterred. However, uncertainty also prevents optimal deterrence because target boards may believe that they can validly enter socially undesirable provisions.¹⁸⁸ Courts can alleviate this problem, at least in part, by adopting bright-line standards that clearly define when target boards can validly enter exclusivity provisions.¹⁸⁹ But if clarity and predictability are therefore the hallmarks of good corporate law, the present legal regime largely fails that test.

b. *Asking the Right Questions*

Judicial review also has failed on a second, and more fundamental, front: Current law focuses on what are essentially side issues. None of the *Great Western*,¹⁹⁰ *Jewel*,¹⁹¹ and *Van Gorkom*¹⁹² lines of cases address the potential for side payments to management. Until courts begin addressing this issue,

185. *Hanson Trust*, 781 F.2d at 291 (Kearse, J., dissenting).

186. Cf. Fischel, *supra* note 98, at 1453 (firms will incur judicially imposed costs of experts prepared to testify that cost is fair); Herzel & Katz, *supra* note 98, at 1191 (increased formalism will increase costs for attorneys, bankers, accountants, consultants, and economists, among others).

187. See Johnson & Siegel, *supra* note 9, at 374-75.

188. See generally Calfee & Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 965-67 (1984) (uncertain application of legal standards may give economic incentives to over-comply or under-comply with them).

189. Even a highly specific rule, however, may not fully eliminate uncertainty. See *id.* at 968 n.7.

190. *Great Western Producers Co-Op v. Great Western United Corp.*, 200 Colo. 180, 613 P.2d 873 (1980) (en banc).

191. *Jewel Cos. v. Pay Less Drug Stores N.W., Inc.*, 741 F.2d 1555 (9th Cir. 1984).

192. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (en banc).

judicial review will remain a costly, dangerous, but essentially meaningless, ritual.

i. Analyzing Exclusivity Provisions

In a critical sense, neither *Great Western* nor *Jewel* got exclusivity provisions right. *Great Western* was wrong because it effectively said that a target board has no authority to grant exclusivity provisions. *Jewel* was wrong too, because it apparently ended the inquiry into the exclusivity provision's validity after concluding that the board had authority to grant the provision. Both courts thus conflated two inquiries — the target board's on-going fiduciary duty to reevaluate whether the transaction is in the shareholders' best interest and the board's authority to grant exclusivity provisions. Courts, however, can, and should, see these inquiries as posing distinct issues.

There are substantial policy arguments in favor of *Jewel*'s conclusion that target boards have the power to enter binding performance promises. Admittedly, an enforceable performance promise is likely to put a late entrant at a disadvantage. Best efforts and no-shop clauses restrict a target board's ability to respond to a higher competing bid or changed business conditions. Performance promises, however, should not significantly affect the viability of competitive bidding. Because shareholders remain free to reject the favored bidder's offer,¹⁹³ the late entrant is free to make a tender offer directly to the target shareholders or conduct a proxy contest against the favored bidder's proposal without incurring liability for tortious interference with contract.¹⁹⁴ Moreover, once a competing bidder institutes a tender offer or proxy contest, the target board must disclose this fact to its shareholders.¹⁹⁵ The competing bidder also will make target shareholders aware of the alternative proposal through its independent efforts. Given the increasing predominance of sophisticated takeover arbitragers and institu-

193. See *supra* note 89 and accompanying text.

194. See *supra* notes 92, 96-97 and accompanying text. Cf. *STV Engineers, Inc. v. Greiner Engineering, Inc.*, 861 F.2d 784, 788 (3d Cir. 1988) (no-shop clause in letter of intent did not preclude group of Greiner's executives from preparing and making competing MBO bid).

195. *R-G Denver, Ltd. v. First City Holdings, Inc.*, 789 F.2d 1469, 1474-75 (10th Cir. 1986); *Jewel*, 741 F.2d at 1564; *Horwitz v. Southwest Forest Industries, Inc.*, 604 F. Supp. 1130, 1134 (D. Nev. 1985); *ConAgra, Inc. v. Cargill, Inc.*, 222 Neb. 136, 138, 382 N.W.2d 576, 587 (1986) (per curiam). Cf. 17 C.F.R. § 240.14a-9(a) (1990) (proxy materials must be materially complete and accurate and must be amended if later events render them materially false or misleading).

tional investors in the shareholder community, it seems unlikely that shareholders will blindly follow a board's recommendation in the face of a truly superior offer.¹⁹⁶ Accordingly, performance promises provide weak security for side payments to management. As such, they do not pose a serious risk of a conflict of interest between target managers and shareholders.

Why then would a rational bidder demand inclusion of such provisions? Although a binding performance promise cannot prevent a late entrant from making a competing bid or preclude shareholders from accepting one, it does constrain the target board's ability to renege on the transaction. Critics of performance promises typically focus on this aspect of such arrangements, arguing that the directors' fiduciary duties obligate them to base their decisions and recommendations on the facts presented at the time shareholders vote on the transaction.¹⁹⁷ These critics, however, frequently fail to recognize that the target often receives equivalent benefits. Accordingly, performance promises are justified, in part, by an explicit quid pro quo. Although the target board cannot renege on the agreement, the favored bidder's board also is bound.¹⁹⁸

Binding the bidder to the agreement can provide necessary protection for the target, which risks significant harm if the bidder reneges in response to changing conditions.¹⁹⁹ Merger agreements generally contain an extensive set of covenants that limit target management's pre-closing discretion to run the firm's business.²⁰⁰ The target thus may fail to respond to changes in the business climate. Furthermore, important personnel may depart out of boredom or because of job security concerns. If the bidder does not ultimately acquire the target,

196. See *supra* note 181.

197. *E.g.*, Johnson & Siegel, *supra* note 9, at 368; Millich, *supra* note 46, at 834-35; Note, *Merger Contracts*, *supra* note 3, at 753-63.

198. See *supra* text accompanying note 11; see, *e.g.*, Hastings-Murtagh v. Texas Air Corp., 649 F. Supp. 479, 485 (S.D. Fla. 1986).

199. *But cf.* Paramount Communications, Inc. v. Time, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,275 n.12 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989) ("[c]ircumstances have rarely if ever arisen in which an offeror need concern itself with likely changes in circumstances affecting its shareholders prior to the proposed closing of its offer").

200. See generally J. FREUND, *supra* note 2, at 293-95 (describing the covenants contained in merger agreements). This Article does not address the issue of whether binding performance promises could be made as part of a letter of intent. See generally Temkin, *supra* note 47 (addressing contractual issues resulting from an "agreement in principle" arising out of corporate acquisition negotiations).

such developments may leave the target in a less competitive posture to the detriment of its shareholders. Mutual exclusivity provisions thus give target shareholders some assurance that a favorable transaction will not be lost, with potentially severe consequences.²⁰¹

Performance promises also provide a negotiating tool for the target board. In return for decreasing the initial bidder's risk that the merger will not go forward, management can insist that the bidder pay a higher price or otherwise offer more favorable terms to the shareholders.²⁰² Indeed, because rational bidders presumably discount their bids to account for the risk that the target board will renege, decreasing this risk through the use of a performance promise should automatically offset any such tendency.

Similar policy arguments also support a conclusion that target boards have the power to enter binding cancellation fee provisions. Admittedly, the target remains liable for the fee, thus imposing an economic cost on a successful competing bidder.²⁰³ Most fee arrangements, however, involve only a small percentage of the value of the transaction.²⁰⁴ This relatively insignificant contingent liability is unlikely to coerce shareholders into accepting an otherwise undesirable transaction. Likewise, there is no reason to believe that a reasonable fee arrangement significantly deters competing bids.²⁰⁵ Finally, because cancellation fees decrease the bidder's risk, management can demand appropriate consideration in return for granting such a provision, thus enhancing shareholder gains.

Accepting the *Jewel* court's view of the board's authority, however, does not require one to reject the *Great Western* view of the target board's ongoing fiduciary duties. The *Great Western* court arguably was correct in holding that the board has an ongoing duty to evaluate whether the terms and conditions of

201. Cf. *Priddy v. Edelman*, 883 F.2d 438, 443 (6th Cir. 1989) (board acted properly in quickly selecting one of two competing bids in light of risk that "the deal might have fallen through, leaving the shareholders worse off").

202. Compare *Johnson & Siegel*, *supra* note 9, at 406-07 (arguing that the no-shop agreement is of some value to an acquiring board and thus the agreement will increase the value of the bid) with *Buxbaum*, *supra* note 4, at 1705, 1712 (arguing that the agreement may not bring a higher bid).

203. S. REED, *supra* note 14, at 753.

204. See *supra* note 23 and accompanying text.

205. See *Samjens Partners I v. Burlington Indus., Inc.*, 663 F. Supp. 614, 625 (S.D.N.Y. 1987) (target board agreed to a termination fee and still received other bids); *Johnson & Siegel*, *supra* note 9, at 410-11 (reasonable cancellation fee will not inhibit competition, although a substantial fee may).

the transaction are in the shareholder's best interest from the time of signing a merger agreement until closing. Suppose that, after signing the exclusive merger agreement, the bidder's financial condition substantially deteriorates. Or suppose the target directors failed, because of their own lack of due diligence, to discover troublesome news about the bidder when entering the definitive merger agreement. It is at least plausible that the target board's fiduciary duties require the board to reconsider the merger in either case. A useful analogy may be the lawyer who is obliged to withdraw a favorable opinion letter because of a subsequent adverse change in the law or because the lawyer failed to discover the contrary law before issuing the initial opinion.²⁰⁶

Adopting the *Great Western* conclusion that target boards have a continuing fiduciary duty to their shareholders, however, does not require one to also accept the *Great Western* conclusion that target boards can freely renege on exclusivity provisions. In a sense, performance promises and cancellation fees are the merger contract's equivalent of a liquidated damages clause. As such, there is a strong economic justification for routinely enforcing these party designed contractual remedies: Like a liquidated damages clause, exclusivity provisions may be considered "an insurance contract written in favor of the innocent party by the breaching party."²⁰⁷

For example, consider the facts of *ConAgra, Inc. v. Cargill, Inc.*²⁰⁸ The target was the second largest producer in the boxed beef industry. ConAgra, desiring to enter this highly competitive industry, presumably placed a high subjective value on completing the acquisition: Not only was the target intrinsically valuable, but ConAgra likely anticipated important synergies from the acquisition.²⁰⁹ The target, moreover, was the best possible insurer against the loss of that subjective valuation. If the acquisition failed to go forward, only the target — through payment of a cancellation fee or damages for breaching its performance promise — could compensate ConAgra for the loss of its anticipated synergistic gains. If courts refused to enforce exclusivity provisions, the target would not consider this potential liability when deciding whether to breach or perform. Efficiency therefore argues for enforcing exclusivity provisions, in

206. I am indebted to Mike Dooley for this analogy.

207. R. COOTER & T. ULEN, *LAW AND ECONOMICS* 293 (1986).

208. 222 Neb. 136, 382 N.W.2d 576 (1986) (per curiam).

209. *Id.* at 139, 382 N.W.2d at 579.

the absence of other costs, because the target will then renege only when the benefits of breaching outweigh the costs. The law would thereby protect the bidder's subjective valuation at the lowest possible cost.²¹⁰

By recognizing the enforceability of exclusivity provisions, the target board's duty resolves into a fairly straight-forward application of efficient breach theory. For example, suppose that the Acquirer board and the Target board enter an exclusive merger agreement in which the Acquirer agrees to purchase Target for \$100,000 and the Target board agrees to use its best efforts to consummate the merger. Before shareholder action on the proposal, a competing bidder offers \$120,000. If the Target board concludes that breaching the best efforts clause to accept the competing bid would result in a damage claim of less than \$20,000, it should breach the agreement, pay damages to Acquirer, and merge with the competing bidder.²¹¹ Because the Target shareholders gain and no other party loses, this breach is both consistent with the Target board's fiduciary duties and efficient. Thus, a rule that enforces exclusivity provisions through a damages remedy in favor of initial bidders, but also imposes ongoing fiduciary duties on target boards, promotes efficiency by assuring that corporations obtain the benefits of both exclusive merger agreements and competitive bidding. In light of this analysis, Part IV of this Article will propose a framework for analyzing exclusivity provisions that should result in their routine judicial enforcement.

ii. Analyzing Lock-Ups

Unlike exclusivity provisions, effective lock-ups pose a severe threat to both free shareholder choice and competitive bidding. If the initial bidder exercises a substantial asset lock-up option, the target will have to operate without crucial assets. As a result, shareholders are coerced into approving the proposed transaction, so as to avoid being left as owners of a rapidly failing business.²¹² Likewise, an asset lock-up option should deter competing bids by making the target much less

210. See R. COOTER & T. ULEN, *supra* note 207, at 293-94. In addition, as with liquidated damage clauses, performance promises and cancellation fees "may be the most efficient means of one party's conveying information about his reliability and his ability to perform the contract." *Id.* at 295.

211. See *id.* at 289-92.

212. R. GILSON, *supra* note 92, at 845; see also *Hanson Trust PLC v. ML SMC Acquisition, Inc.*, 781 F.2d 264, 282 (2d Cir. 1986) (shareholders must bear the risk of deal falling through, including risk of significant undervaluation);

attractive.²¹³

A stock lock-up option may be even more effective. If the initial bidder exercises a stock lock-up involving a significant percentage of the target's outstanding shares, the bidder (perhaps in conjunction with insider holdings) may acquire sufficient voting power to approve its proposed transaction regardless of the views of minority shareholders.²¹⁴ Likewise, such a lock-up could give the initial bidder a controlling interest in the target even if all other shareholders tendered their stock to a competing bidder. Moreover, even if the stock lock-up option did not give the holder enough shares to independently approve the merger, it might coerce shareholders into accepting the offer or preclude competing bids because, by exercising the option, the initial bidder will effectively impose a

Thompson v. Enstar Corp., 509 A.2d 578, 583 (Del. Ch. 1984) (shareholders bear risk that stock price may drop after shareholders meeting).

213. See Helman & Davis, *supra* note 6, at 16-18. An asset lock-up's deterrent effect largely depends on avoiding any shareholder approval requirement. In general, shareholder approval is statutorily mandated only when exercise of the option would result in the sale of "all or substantially all" of the target corporation's assets. See, e.g., DEL. CODE ANN., tit. 8, § 271 (1988). The Revised Model Act has done away with the substantially all distinction for purposes of determining the need for shareholder approval, instead focusing on whether the transaction is "in the regular course of business." See MODEL BUSINESS CORP. ACT ANN. §§ 12.01-.02 (1985). Although most statutes speak of sales, sale of asset statutes have been held equally applicable to options. See, e.g., Texas Co. v. Z. & M. Indep. Oil Co., 156 F.2d 802, 865 (2d Cir. 1946) (applying New York law). There are no bright-line definitions of what constitutes substantially all of a corporation's assets. Many courts focus on the nature of the assets, requiring shareholder approval only when sale of the assets would work a fundamental change in the nature of the corporation. See, e.g., Good v. Lackawanna Leather Co., 96 N.J. Super. 439, 456, 233 A.2d 201, 210 (1967) (test is not for amount involved but for nature of transaction); Eisen v. Post, 3 N.Y.2d 518, 523, 146 N.E.2d 779, 780, 169 N.Y.S.2d 15, 18 (1957) (same). Other courts, particularly those of Delaware, take a somewhat more quantitative approach, focusing on the value of the assets. See, e.g., Katz v. Bregman, 431 A.2d 1274, 1276 (Del. Ch. 1981); Gimbel v. Signal Cos., 316 A.2d 599, 605 (Del. Ch.), *aff'd on other grounds*, 316 A.2d 619 (Del. 1974). See generally E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 400-01 (1972); R. GILSON, *supra* note 92, at 523-26. In general, however, the magnitude of the transaction required to trigger the statutes has been so large as to preclude their application to asset lock-ups. See, e.g., Whittaker Corp. v. Edgar, 535 F. Supp. 933, 951-52 (N.D. Ill. 1982); Mobil Corp. v. Marathon Oil Co., [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,375, at 92,283 (S.D. Ohio Dec. 7, 1981), *rev'd on other grounds*, 669 F.2d 366 (6th Cir.), *cert. denied*, 456 U.S. 982 (1982).

214. Absent unusual circumstances, dissenting shareholders would be relegated to their statutory appraisal rights. Cf. Weinberger v. UOP, Inc., 457 A.2d 701, 703-04 (Del. 1983) (in cash-out mergers shareholders relegated to appraisal remedy, absent unusual facts).

substantial penalty on the target.²¹⁵

Of course, not all lock-up options have the draconian effects just described. When the optioned shares or assets are a relatively small percentage of the target's overall value, the option is little more than alternative means of structuring a cancellation fee. As such, these options should "not affect the vote of the stockholders . . . or stand in the way of possible bids by other interested parties."²¹⁶ Thus, courts must identify those lock-ups that effectively preclude competitive bidding, and neutralize the potential conflict of interest that may taint a decision to grant such a lock-up.

Unfortunately, lock-up decisions, such as *Hanson Trust*, that determine the validity of lock-ups based on the reasonableness of the board's decision to enter into the provision are asking the wrong question.²¹⁷ A poorly negotiated sales contract is not unenforceable simply because the agent who negotiated the

215. See *Hanson Trust*, 781 F.2d at 281-83 (lock-up option would effectively end bidding); *Enstar*, 509 A.2d at 583 (lock-up would give purchaser control of voting); *Herzel*, *supra* note 4, at 173-75 (stockholders have very little choice but to accept offer); *Johnson & Siegel*, *supra* note 9, at 373 (lock-up removes any real choice for shareholders). As with asset lock-ups, a stock lock-up option's deterrent effect requires the parties to avoid any shareholder approval requirement. The option therefore typically will be limited by the number of treasury or authorized but unissued shares, because increasing the number of authorized but unissued shares usually requires shareholder approval of an amendment to the corporation's charter. See MODEL BUSINESS CORP. ACT ANN. §§ 2.02, 6.01, 10.03 (1985); DEL. CODE ANN., tit. 8, § 242 (1988). In the case of targets listed on the New York or American Stock Exchanges, the parties' flexibility is further limited by exchange rules requiring shareholder approval of stock issuances exceeding, respectively, 18.5% or 20% of the outstanding shares. NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 312.00 (1983); AMERICAN STOCK EXCHANGE, COMPANY GUIDE § 712 (1983). The American Stock Exchange has proposed raising its threshold to 25%. Exchange Act Release No. 26,263 (Nov. 15, 1988). The short-swing profit provisions of Securities Exchange Act of 1934, 15 U.S.C. § 16(b) (1980), also act as an additional constraint on the size of stock lock-up options. See *supra* note 15. Despite these limitations, lock-up options covering a greater number of target shares than those presently outstanding are not unheard of. See, e.g., *Data Probe Acquisition Corp. v. Datatab, Inc.*, 568 F. Supp. 1538, 1556-57 (S.D.N.Y. 1983) (acquirer granted an option to buy authorized but unissued shares equivalent to 200% of the target's outstanding voting stock).

216. *Smith v. Pritzker*, No. 6,342, slip op. (Del. Ch. July 6, 1982), reprinted in 8 DEL. J. CORP. L. 406, 415 (1983), *rev'd on other grounds sub. nom Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (en banc). See also *Yanow v. Scientific Leasing, Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,660, at 98,033 n.6 (Del. Ch. Feb. 8, 1988) (option was not a lock-up that would preclude higher bids).

217. See *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986).

contract on behalf of a corporate purchaser was incompetent. Rather, the seller can enforce the contract according to its terms, and the corporation's remedy is against the agent for the losses it has suffered. Similarly, in some jurisdictions, a trustee having a power of sale generally may enter into a binding sales contract without first auctioning the assets to be sold.²¹⁸ If the assets are sold at an unreasonably low price, the contract remains binding even if a third party makes a higher offer prior to closing.²¹⁹ The beneficiary's only recourse is against the trustee under a negligence or breach of duty theory,²²⁰ the beneficiary has no recourse against the purchaser.²²¹

The basic issue then is not whether the lock-up is a good deal for the shareholders. If it is a bad deal, the shareholders' remedy is for money damages against the board (assuming they can overcome the business judgment rule), not an injunction against the lock-up.²²² Rather, the issue is the legitimacy of the

218. See, e.g., *Hatcher v. United States Nat'l Bank*, 56 Or. App. 643, 652, 643 P.2d 359, 365 (1982) (trustee may "test market" or obtain an independent appraisal of property); *Allard v. Pacific Nat'l Bank*, 99 Wash. 2d 394, 405, 663 P.2d 104, 111 (1983) (same). But see *Rippee v. Denver United States Nat'l Bank*, 273 F. Supp. 718, 734 (D. Colo. 1967) (implying that while open bidding may not be required, trustee may not dispose of assets in a private sale where there is another interested party who may pay more); *Lockwood v. OFB Corp.*, 305 A.2d 636, 638 (Del. Ch. 1973) (trustee "should arrange for competitive bidding if that is possible and appropriate to the asset involved"); *State v. Hartman*, 54 Wis. 2d 47, 54, 194 N.W.2d 653, 656 (1972) (trustee must place property on open market before selling).

219. See Annotation, *Second and Higher Offer as Affecting Final Approval of Trustee's Sale*, 1 A.L.R. 3d 629, 630 (1965); 76 AM. JUR. 2d *Trusts* § 454 (1974). The courts are split as to whether a trustee has a duty to disavow the initial contract where the sale is subject to court approval and a higher bid is made before court approval is obtained. Compare *Gilden v. Harris*, 197 Md. 32, 42, 78 A.2d 167, 171 (1951) (uphold sale) and *In re Trust Estate of Strauss*, 11 Wis. 2d 410, 413-14, 105 N.W.2d 553, 555 (1960) (same) with *Kane v. Girard Trust Co.*, 351 Pa. 191, 196-97, 40 A.2d 466, 469 (1945) (trustee is bound to accept higher bid until title passes). See also *Evans v. Hunold*, 393 Ill. 195, 199, 65 N.E.2d 373, 375 (1946) (same).

220. RESTATEMENT (SECOND) OF TRUSTS, *supra* note 147, § 190 comment i; A. SCOTT & W. FRATCHER, *supra* note 147, §§ 190.6, 208.6.

221. See, e.g., *Wittick v. Miles*, 274 Or. 1, 10, 545 P.2d 121, 126-27 (1976). Of course, corporate law differs from trust law in that it is premised on owner participation in significant decisions. Buxbaum, *supra* note 4, at 1672. Exclusivity provisions, especially lock-ups, are thus often criticized on the grounds that they adversely affect the shareholders' right to make the final decision with respect to control transactions. On close examination, this criticism is not very persuasive. See *infra* notes 362-64 and accompanying text.

222. Of course, the recent wave of director liability statutes may limit the effectiveness of this remedy. See *supra* note 148; see also *infra* text accompanying notes 347-49 (describing the Delaware statute's effectiveness on incentives of target directors). However, those statutes do not preclude equitable

agreement. Was the agreement within the power or authority of the board? Because we have the greatest reason to doubt the board's authority to do something when it is disabled by a conflict of interest, duty of loyalty questions necessarily implicate the legitimacy of lock-ups in a way that duty of care questions do not. An inquiry limited to the duty of care is appropriate only for board decisions that contain a low risk of management misconduct. Thus, lock-ups granted in negotiated acquisitions are properly analyzed as a duty of loyalty question — the validity and enforceability of a lock-up should hinge on the likelihood that it is being used to protect side payments to management.

Identifying those negotiated acquisitions that contain side payments and crafting an appropriate judicial response to them raises several difficult problems. For one, it seems clear that management's conflict of interest is only a potential problem — not every negotiated acquisition is motivated by or involves improper side payments. Moreover, even when side payments do occur, they are extremely difficult to detect.²²³ For example, a bidder might legitimately offer target managers improved benefits to retain experienced, knowledgeable key employees. In the absence of the proverbial smoking gun, what evidence should a court require to prove such benefits were improper side payments used to obtain management's cooperation?

Clearly, the greater coercive and deterrent effects of lock-ups mandates a more restrictive approach to lock-up validity than the approach applied to exclusivity provisions. As this Article proposes in Part IV, the most sensible course for courts to take in this situation is to adopt a set of prophylactic rules designed to assure that negotiated acquisitions are reviewed by the marketplace. Substituting a market test for judicial review provides an effective constraint on management, while avoiding the need to resolve subjective and complex questions of motive.²²⁴ Before describing this alternative to judicial review,

relief for breaches of the duty of care. There may be factual patterns that would justify enjoining an especially disadvantageous deal if the plaintiff is able to establish the traditional bases of equitable relief, including irreparable injury and inadequacy of monetary relief.

223. See Bebchuk, *supra* note 150, at 25 n.8; Easterbrook & Fischel, *Proper Role*, *supra* note 6, at 1180 n.49.

224. Cf. CORPORATE GOVERNANCE: DRAFT NO. 9, *supra* note 112, at 9 ("market review of the fairness of the terms of a management buyout is preferable to judicial review").

however, this Article will review a developing line of authority that centers on the role of competitive bidding.

III. THE DUTY TO AUCTION CONTROL FROM *REVLON TO TIME*

Part II demonstrated that competitive bidding provides the best available constraint on self-dealing by target managers in the negotiated acquisition setting. Unfortunately, neither of the two traditional review methodologies focus on the role of competitive bidding, instead relying on other, largely ineffective, constraints. This Part turns to a line of authority that expressly mandates an auction of corporate control in certain types of takeover contests.

The duty to auction control emerged as Delaware law governing target responses to hostile takeover bids evolved. Delaware courts initially used the so-called "primary purpose test" in reviewing takeover defenses. Under this standard, courts refused to give directors the immediate benefit of the business judgment rule's presumption of good faith. Rather, directors had the initial burden of showing that they had reasonable grounds to believe that a danger to corporate policy and effectiveness existed and that they did not act for the primary purpose of preserving their own incumbency. The directors, however, merely had to show good faith and reasonable investigation; courts would not hold them liable for an honest mistake of judgment.²²⁵

Because management could routinely identify some policy conflict with the bidder, primary purpose analysis added little to the highly deferential treatment of board decisions mandated by the traditional business judgment rule.²²⁶ Accordingly, the primary purpose test was an inadequate response to the potential conflict of interest present when management responds to a takeover bid.²²⁷ The Delaware Supreme Court eventually recognized this flaw, and responded in *Unocal Corp. v. Mesa Petroleum Co.*²²⁸ The test adopted in *Unocal* requires directors who

225. See, e.g., *Cheff v. Mathes*, 41 Del. Ch. 166, 175, 199 A.2d 548, 555 (1964).

226. Gilson, *Structural Approach to Corporations*, *supra* note 152, at 829.

227. *Id.* at 826-31.

228. 493 A.2d 946, 954-55 (Del. 1985). See also *Dynamics Corp. of Am. v. CTS Corp.*, 805 F.2d 705, 708 (7th Cir. 1986) (applying Delaware Court's reasoning to Indiana law); *Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir. 1986) (same), *rev'd on other grounds*, 481 U.S. 69 (1987); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (similarly abandoning the primary purpose test). See generally Gilson & Kraakman, *Delaware's Interme-*

adopt a takeover defense to "show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed."²²⁹ In addition to requiring proof of good faith and reasonable investigation, this standard also requires target directors to prove that the defense was authorized by law, not undertaken solely or primarily out of a desire to perpetuate the directors or officers in office, and, most importantly, reasonable in relation to the threat posed.²³⁰ As a result, courts no longer simply rubber-stamp a target board's decision to take defensive measures, but review it carefully to make sure the board really was acting in the best interests of the corporation.²³¹

As applied to exclusivity provisions and lock-ups, the net effect of these developments was a greater emphasis on the importance of competitive bidding in corporate acquisitions.²³² A standard closely related to the primary purpose test was applied to early challenges of lock-up arrangements. This standard imposed on a competing bidder challenging the lock-up the initial burden of showing that self-interest or bad faith tainted the target director's grant of the lock-up.²³³ If the competing bidder failed to make such a showing, the business judgment rule precluded judicial review of the board's decision.²³⁴

diate Standard for Defensive Tactics: Is there Substance to Proportionality Review?, 44 BUS. LAW. 247 (1989) (discussing Delaware's *Unocal* standard for analyzing a takeover defense); Steinberg, *Tender Offer Regulation: The Need for Reform*, 23 WAKE FOREST L. REV. 1, 4-17 (1988) (same).

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

230. *Id.* at 953-55.

231. *Dynamics Corp.*, 805 F.2d at 708. This analysis will be applied to a challenged takeover defense not only when it is adopted, but also when it is utilized by the target in connection with a particular tender offer. See *Moran*, 500 A.2d at 1354.

232. Landefeld, *Business Auctions Take Hold*, NAT'L L.J., May 15, 1989, at S2, col. 2. When a competing bidder objects to a lock-up, it is essentially making the same claims which a hostile bidder makes against takeover defensive tactics. In either case, the bidder complains that the target has erected an impermissible barrier to its offer. Not surprisingly, judicial analysis of lock-ups has frequently paralleled the rules governing takeover defenses. R. GILSON, *supra* note 92, at 838.

233. *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 702 (2d Cir. 1980) (citing *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980)).

234. *Id.* During the early 1980s, hostile bidders also frequently argued that defensive lock-ups constituted "manipulative" practices in violation of the Securities Exchange Act of 1934 § 14(e). See 15 U.S.C. § 78n(e) (1988) (prohibiting, in pertinent part, "fraudulent, deceptive, or manipulative acts or practices" in connection with a tender offer). This tactic met with some initial success. See, e.g., *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 367 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982). But see, e.g., *Data Probe Acquisition*

If the competing bidder made such a showing, however, courts required the directors to show that the transaction was fair and reasonable to the corporation.²³⁵ To sustain the burden of showing self-interest or bad faith, the competing bidder had to show that a desire to perpetuate incumbent target managers in office motivated the lock-up.²³⁶ Courts, however, declined to find improper motives merely because target management would remain in office if the favored bidder prevailed.²³⁷ Likewise, courts found that a target board's resistance to a competing bidder did not demonstrate self-interest.²³⁸ Rather, courts permitted target managers to take affirmative steps to facilitate consummation of the merger with the favored bidder, and re-

Corp. v. Datatab, Inc., 722 F.2d 1, 4 (2d Cir. 1983) (defensive lock-up not successful), *cert. denied*, 465 U.S. 1052 (1984); Whittaker Corp. v. Edgar, 535 F. Supp. 933, 949 (N.D. Ill. 1982) (same); Marshall Field & Co. v. Icahn, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,616, at 93,059 (S.D.N.Y. March 26, 1982) (same). In 1985, however, the Supreme Court held that misrepresentation or nondisclosure is an essential element of a manipulation claim under § 14(e). *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 12 (1985). As a result, § 14(e) is essentially inapplicable to exclusive merger agreements that are fully and accurately disclosed. *See Note, Down But Not Out — The Lock-Up Option Still Has Legal Punch When Properly Used*, *supra* note 164, at 1128. Competing bidders and objecting target shareholders are thus largely limited to state law claims based on target directors' fiduciary duties.

It is conceivable, although perhaps unlikely, that Congress will act to prohibit lock-ups in certain situations. Legislation introduced, but not adopted, during the 100th Congress would have made it unlawful for any company "to establish or implement" a lock-up, among other defensive tactics, during a tender offer, if doing so would violate rules to be adopted by the SEC, unless the defense was approved by the shareholders in a manner also to be governed by new SEC rules. Tender Offer Reform Act of 1987, H.R. 2172, 100th Cong., 1st Sess. § 14 (1987).

235. *Crouse-Hinds*, 638 F.2d at 702 (citing *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980)).

236. *Id.* at 702-04; *Buffalo Forge Co. v. Ogden Corp.*, 555 F. Supp. 892, 903-04, (W.D.N.Y.), *aff'd*, 717 F.2d 757 (2d Cir.), *cert. denied*, 464 U.S. 1018 (1983); *Whittaker Corp.*, 535 F. Supp. at 950-51.

237. *Crouse-Hinds*, 634 F.2d at 702. A number of older Delaware cases upheld asset sales despite evidence that incumbent directors or officers would have employment arrangements with the acquiring company. *See, e.g., Cottrell v. Pawcatuck Co.*, 36 Del. Ch. 169, 172, 128 A.2d 225, 227 (1956), *appeal dismissed and cert. denied*, 355 U.S. 12 (1957); *Smith v. Good Music Station, Inc.*, 36 Del. Ch. 262, 266-67, 129 A.2d 242, 245-46 (1957); *Baron v. Pressed Metals of Am., Inc.*, 35 Del. Ch. 325, 329, 335, 117 A.2d 357, 360, 364 (1955), *aff'd*, 35 Del. Ch. 581, 123 A.2d 848 (1956); *Mitchell v. Highland-Western Glass Co.*, 19 Del. Ch. 326, 328-29, 167 A. 831, 832-33 (1933). *Cf. Treadway Cos. v. Care Corp.*, 638 F.2d 357, 383 (2d Cir. 1980) (applying New York law, self-dealing could not be found where all directors were to resign after an acquisition).

238. *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 704 n.24 (2d Cir. 1980).

fused to require them to reconsider the initial offer when a third party made a competing bid.²³⁹ In short, absent the proverbial smoking gun, it was virtually impossible for competing bidders to show that improper entrenchment purposes motivated a merger.²⁴⁰

Gradually, however, courts began to recognize the central role of competitive bidding. *Smith v. Van Gorkom*,²⁴¹ for example, implied that one means of satisfying the target board's duty of care is through a meaningful market test of the favored bidder's proposal.²⁴² Similarly, *Hanson Trust PLC v. ML SCM Acquisition, Inc.*²⁴³ sharply criticized the use of a lock-up to end an active bidding contest.²⁴⁴ This trend came to a head in the Delaware Supreme Court's ground-breaking decision, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,²⁴⁵ the first significant case explicitly mandating an auction process in a takeover situation.

A. ORIGINS AND EVOLUTION OF THE DUTY TO AUCTION CONTROL

Revlon involved defensive measures taken in response to a hostile bidder, Pantry Pride. The fight for control began when Pantry Pride approached Revlon with an unsolicited cash tender offer for any or all of Revlon's outstanding stock at \$47.50 per common share.²⁴⁶ In response, Revlon's board commenced a partial self-tender offer in which Revlon exchanged

239. *Id.* at 703-04. See also *Whittaker Corp. v. Edgar*, 535 F. Supp. 933, 951 (N.D. Ill. 1982) (holding the board of directors of a target company may promote consummation of a transaction judged to be in the best interests of the shareholders even if to do so might cause the hostile tender offer to withdraw).

240. See, e.g., *Crouse-Hinds*, 634 F.2d at 704; *Buffalo Forge*, 717 F.2d at 759; *Whittaker Corp.*, 535 F. Supp. at 950-51.

241. 488 A.2d 858 (Del. 1985) (en banc).

242. See *supra* note 123 and accompanying text.

243. 781 F.2d 264 (2d Cir. 1986).

244. *Id.* at 281; see also *Thompson v. Enstar Corp.*, 509 A.2d 578, 583 (Del. Ch. 1984) (court giving careful scrutiny to lock-up provisions in light of their potential to chill competitive bidding).

245. 506 A.2d 173 (Del. 1986).

246. This factual summary is drawn from the Delaware Supreme Court's decision, *id.* at 176-79, and from the previous opinion of the Delaware Chancery Court, *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1242-46 (Del. Ch. 1985). Revlon's board of directors initially responded by instituting a stock repurchase program and adopting a so-called "Note Purchase Rights Plan," a variant on the poison pill takeover defense. The Revlon plan differed from the classic poison pill by giving shareholders the right to exchange their shares for newly issued Revlon notes, instead of the

10 million outstanding Revlon common shares for newly issued subordinated notes and preferred stock.²⁴⁷ In turn, Pantry Pride made a new tender offer at \$42 per common share.²⁴⁸

Shortly after the Revlon board rejected Pantry Pride's \$42 per share offer, it authorized management to enter into negotiations with other prospective bidders. Forstmann Little & Co. (Forstmann) and Adler & Shaykin made separate white knight offers in response to management's efforts. After Pantry Pride increased its bid to \$53 per share, Revlon's board agreed to a leveraged buyout by Forstmann at \$56 per share. Pantry Pride countered by offering \$56.25 per share and announced that it would engage in fractional bidding, topping any Forstmann bid with a slightly higher one. Forstmann responded with a new offer of \$57.25 per share, conditioned on Revlon's acceptance of several exclusivity provisions. Forstmann's principal demand was for an asset lock-up option on two Revlon divisions at an exercise price substantially below the value given them by Revlon's financial adviser. Forstmann also insisted on a no-shop clause and a \$25 million cancellation fee, payable if any other party acquired more than 19.9% of Revlon's stock. Revlon acceded to Forstmann's terms and also agreed to redeem its poison pill and waive certain anti-takeover covenants in its notes. Pantry Pride responded by raising its offer to \$58 per share and by seeking judicial invalidation of Revlon's poison pill, the exchange offer, and the exclusivity provisions granted to Forstmann.²⁴⁹

The Delaware Supreme Court began its analysis of these defensive measures by noting that lock-up options and other such provisions are valid under Delaware law unless they are tainted by director self-interest or other breach of fiduciary duty.²⁵⁰ The court, however, also noted that it will not automatically give the board's decision to enter these provisions the benefit of the business judgement rule, but will closely scrutinize the decision under the standard articulated in *Unocal* to determine whether the board breached its fiduciary duty.²⁵¹

more usual right to purchase additional shares of common stock. See *Revlon*, 506 A.2d at 177.

247. *Id.*

248. *Id.* at 177-79.

249. *Id.* See also *supra* note 246 (describing Revlon's stock repurchase program).

250. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176, 183-84 (Del. 1986).

251. *Id.* at 180-81.

Applying the *Unocal* standard to the Revlon board's defensive actions, the Delaware Supreme Court upheld the poison pill and the exchange offer, deeming them reasonable responses to an inadequate bid.²⁵² In turning to the lock-up arrangement, however, the court added a new wrinkle to its analysis:

The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The 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.²⁵³

In particular, exclusivity provisions or lock-ups that end an active auction will be subject to exacting scrutiny to determine whether they are reasonable in relation to the threat posed by the disfavored bidders.²⁵⁴ Because the Revlon lock-up provisions ended the auction in return for minimal improvement in the final offer, and the Revlon board largely intended the provision to protect its own interests, the Delaware Supreme Court upheld the lower court's injunction against the option.²⁵⁵ Because the no-shop clause and the cancellation fee were part of an overall effort to thwart Pantry Pride's efforts, their invalidity followed in due course.²⁵⁶

Target directors are given considerable discretion in conducting a control auction mandated by *Revlon*. They need not be passive observers of market competition.²⁵⁷ Directors, however, must scrupulously adhere to ordinary notions of fair-

252. *Id.* The court found that the board's decision to enter the poison pill and exchange offer was consistent with its fiduciary duty because the board could have reasonably believed that Pantry Pride's offer was grossly inadequate and thus constituted a harmful threat to Revlon shareholders. Accordingly, the board could properly take defensive measures to forestall the harmful takeover. *Id.* at 182.

253. *Id.*

254. *Id.* at 183.

255. *Id.* at 184.

256. *Id.*

257. *CRTF Corp. v. Federated Dep't Stores, Inc.*, 683 F. Supp. 422, 441 (S.D.N.Y. 1988); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 n.16 (Del. 1986).

ness.²⁵⁸ Their "primary objective, and essential purpose, must remain the enhancement of the bidding process for the benefit of the stockholders."²⁵⁹ If the target board gives favored treatment to one bidder at any stage of the process, it must justify the favored treatment under a *Unocal*-like intermediate standard of review. In a post-*Revlon* case, the Delaware Supreme Court articulated this standard as follows:

At the outset, the plaintiff must show, and the trial court must find, that the directors of the target company treated one or more of the respective bidders on unequal terms. . . .

In the face of disparate treatment, the trial court must first examine whether the directors properly perceived that shareholder interests were enhanced [by favoring one bidder]. In any event the board's action must be reasonable in relation to the advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests.²⁶⁰

Only if the directors' actions pass muster under this test are they entitled to the protection of the business judgment rule.²⁶¹

Before favored treatment of one bidder can withstand review under the above test, the board probably is obligated to initially negotiate in good faith with each of the competing bidders.²⁶² At a minimum, the board must be adequately informed of the material facts and engage in a thorough review of available options.²⁶³ In determining which bid is in the shareholders' best interests, however, target directors need not blindly focus on price to the exclusion of other relevant factors. The board also may consider the proposed form of considera-

258. *Mills Acquisition Co. v. Macmillan, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,072, at 91,025 (Del. Nov. 2, 1988).

259. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1287 (Del. 1989). See also *Black & Decker Corp. v. American Standard, Inc.*, 682 F. Supp. 772, 785-87 (D. Del. 1988) (unequal treatment of bidders at an auction was not justified by considerations that did not benefit the stockholders); *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 781-82 (Del. Ch. 1988) (the board's duty is to achieve the best possible transaction for its shareholders).

260. *Mills*, 559 A.2d at 1288.

261. *Id.* Where management breaches its *Revlon* duties and is interested in the outcome of the transaction, the intrinsic fairness standard applies. *Id.* at 1279.

262. See *Plaza Sec. Co. v. Fruehauf Corp.*, 643 F. Supp. 1535, 1542 (E.D. Mich. 1986); *Mills*, 559 A.2d at 1281-83; *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986); *Hecco Ventures v. Sea-Land Corp.*, No. 8486, slip op. (Del. Ch. May 19, 1986), reprinted in 12 DEL. J. CORP. L. 282, 289-90 (1987).

263. *In re Holly Farms Corp. Shareholders Litig.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,349, at 92,315-16 (Del. Ch. March 22, 1989); *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,713-14 (Del. Ch. Jan. 31, 1989).

tion, tax consequences, firmness of financing, antitrust or other regulatory obstacles and timing.²⁶⁴ Some jurisdictions, although not Delaware, also permit the board to consider the interests of non-shareholder constituencies, such as employees, affected communities, creditors, suppliers and customers.²⁶⁵

Assuming that two bids are comparable as to these other factors, the target board's duty is to obtain the highest price for the shareholders. In this circumstance, whether a target board's decision to grant an exclusivity provision to one bidder will pass muster under the intermediate standard of review depends on the exclusivity provision's effect on the auction process. Like the Second Circuit in *Hanson Trust*, the Delaware Supreme Court distinguishes between exclusivity provisions that draw an otherwise unwilling bidder into the contest and those that end an active auction by effectively foreclosing further bidding.²⁶⁶ For many observers, however, this distinction

264. *Cottle v. Storer Communication, Inc.*, 849 F.2d 570, 577 (11th Cir. 1988); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1988); *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 781 n.7 (Del. Ch. 1988); *RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,712 (by implication); *Citron v. Fairchild Camera & Instrument Corp.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,915, at 90,102-03 (Del. Ch. May 19, 1988); *Freedman v. Restaurant Assoc. Indus., Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502, at 97,220 (Del. Ch. Oct. 16, 1987).

265. *Compare* *Keyser v. Commonwealth Nat'l Fin. Corp.*, 675 F. Supp. 238, 265-66 (M.D. Pa. 1987) (under Pennsylvania statute, directors may consider non-shareholder interests) *with* *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) ("concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress"). Some states have implicitly rejected this aspect of *Revlon* by adopting statutes permitting directors to consider non-shareholder interests in making takeover and other corporate decisions. *See generally* R. WINTER, R. ROSENBAUM, M. STUMPF & L.S. PARKER, *STATE TAKEOVER STATUTES AND POISON PILLS* 55-56 (1988) [hereinafter *TAKEOVER STATUTES AND POISON PILLS*] (surveying the various state statutes). Whether directors should be permitted to consider the interests of non-shareholder constituencies in selecting a bid raises difficult questions that lie outside the scope of this Article and as to which other commentators are sharply divided. *Compare, e.g.*, Lipton, *supra* note 179, at 35-43 and Shaffer, *The Tension Between Law in the American Tradition and the Religious Tradition*, in *THE WEIGHTIER MATTERS OF THE LAW* 315, 328-35 (J. Witte & F. Alexander eds. 1988) *with* Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 181. *See also* Karmel, *The Duty of Directors to Non-Shareholder Constituencies in Control Transactions — A Comparison of U.S. and U.K. Law*, 25 WAKE FOREST L. REV. 61, 61-75 (1990).

266. *Mills*, 559 A.2d at 1286; *Revlon*, 506 A.2d at 183. *See* *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 272 (2d Cir. 1986); *Black & Decker Corp. v. American Standard, Inc.*, 682 F. Supp. 772, 784 (D. Del. 1988);

has not been particularly helpful. "[E]ven when designed to promote another bid, a good (i.e., effective) lock-up may well end the bidding after that one last bid it induces is on the table."²⁶⁷ Thus, when price is the target board's sole concern, courts have yet to develop a workable distinction between permissible and impermissible exclusivity provisions. The Delaware Supreme Court currently may be focusing on one or more of several different factors when determining where to draw the line.

The court may be focusing on the effectiveness of the provisions — whether the provisions in fact preclude any party other than the favored bidder from acquiring the target. Under this approach, the court would uphold only those provisions that elicit an additional bid, but leave other parties free to continue the bidding. This approach, however, smacks of an unusual degree of judicial second-guessing, as the effectiveness of a lock-up often is apparent only with hindsight.²⁶⁸ Moreover, because courts have upheld auction-ending provisions in practice, admittedly most often where no one appears willing to top the favored bidder's offer, they presumably have rejected this approach.²⁶⁹

Alternatively, the court may be focusing on the timing of exclusivity provisions. In other words, the target board may simply need to allow a sufficient number of bidding rounds before granting an exclusivity provision. In fact, exclusivity provisions granted after several rounds of well-publicized bidding have received more favorable judicial treatment than comparable provisions granted early in an auction.²⁷⁰ It is unlikely, however, that there is any magic number of bidding rounds that will validate the decision to grant exclusivity provisions.

In fact, the court seems to be focusing on whether the board obtained substantially more favorable terms from the favored bidder in return for the exclusivity provision or lock-

Samjens Partners I v. Burlington Indus., Inc., 663 F. Supp. 614, 624 (S.D.N.Y. 1987).

267. *Freedman*, [1987-1888 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 97,219 n.31. See also *Cottle*, 849 F.2d at 575-76; *Herzel*, *supra* note 4, at 177; *Johnson & Siegel*, *supra* note 9, at 374-75.

268. *Herzel*, *supra* note 4, at 177; *Johnson & Siegel*, *supra* note 9, at 375.

269. *E.g.*, *Cottle v. Storer Communication, Inc.*, 849 F.2d 570, 576-77 (11th Cir. 1988); *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 781-84 (Del. Ch. 1988).

270. See, *e.g.*, *Samjens Partners I v. Burlington Indus., Inc.*, 663 F. Supp. 614, 619, 625 (S.D.N.Y. 1987); *Hecco Ventures v. Sea-Land Corp.*, No. 8486, slip op. (Del. Ch. May 19, 1986), *reprinted in* 12 DEL. J. CORP. L. 282, 289-90 (1987).

up.²⁷¹ When the target board obtains only a minimal increase in the final bid in return for granting an exclusivity provision or lock-up, the board's action is unlikely to pass muster.²⁷² On the other hand, when the target board obtains a significant price increase in return for granting exclusivity, judicial review has been more favorable.²⁷³ Even in this circumstance, however, the target board probably should make one final attempt to negotiate with the remaining bidders. If a better offer is not promptly forthcoming, the board may validly grant exclusivity provisions.²⁷⁴

B. THE CHANGE IN CONTROL TRIGGER

What actions a target board must take to satisfy *Revlon* is not the only debatable question arising from that case. The *Revlon* court also failed to clearly articulate what events trigger the *Revlon* duty to auction control. On its facts, *Revlon* arguably was consistent with prior Delaware precedent. Courts long have required a fiduciary presented with two or more offers having substantially similar non-price terms to accept the higher offer.²⁷⁵ The *Revlon* board was faced with just such a situation. Pantry Pride and Forstmann had made essentially

271. A fourth interpretation of the *Revlon* standard also is possible. The court simply may be requiring the target board to conduct a fair auction and then give the lock-up to the party that makes the best bid. The Eleventh Circuit has seemingly so interpreted *Revlon*:

All auctions must end sometime, and lock-ups by definition must discourage other bidders. The question therefore is not whether the asset lock-up granted to [the favored bidder] effectively ended the bidding process. The question is whether [the target] conducted a fair auction, and whether [the favored bidder] made the best offer.

Cottle, 849 F.2d at 576 (citations omitted). As shall be developed below, this interpretation would most closely align *Revlon* to the standard proposed herein. See *infra* notes 363-79 and accompanying text.

272. See, e.g., *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1286 (Del. 1988); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 183-84 (Del. 1986).

273. See, e.g., *Cottle*, 849 F.2d at 576-77.

274. See *Mills*, 559 A.2d at 1285-87.

275. See, e.g., *Wilmington Trust Co. v. Coulter*, 41 Del. 548, 557, 200 A.2d 441, 448 (1964); *Thomas v. Kempner*, Nos. 4138 & 4174, slip op. (Del. Ch. Jan. 5, 1977), reprinted in 5 DEL. J. CORP. L. 131, 134-35 (1980); *Smith v. Good Music Station, Inc.*, 36 Del. Ch. 262, 272-73, 129 A.2d 242, 248 (1957); *Robinson v. Pittsburgh Oil Refining Corp.*, 14 Del. Ch. 193, 200, 126 A. 46, 49 (1924); see also *Freedman v. Restaurant Assoc. Indus., Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502, at 97,219 (Del. Ch. Oct. 16, 1987) (finding *Revlon* consistent with this line of cases); cf. *Simkins Indus., Inc. v. Fibreboard Corp.*, No. 5369, slip op. (Del. Ch. July 28, 1977), reprinted in 3 DEL. J. CORP. L. 144, 146-48 (1977).

identical offers.²⁷⁶ Moreover, Pantry Pride had stated an intent to top any Forstmann offer.²⁷⁷ Under the circumstances, requiring the board to sell the company to the highest bidder arguably did not mark a significant change in the law. Accordingly, it is not surprising that subsequent hostile takeover cases consistently have required a control auction when the target board is faced with multiple bidders.²⁷⁸

A broad application of *Revlon* to all corporate acquisitions, however, would be inconsistent with pre-*Revlon* precedents. These prior decisions almost uniformly rejected any requirement that a target board shop the company before agreeing to a friendly acquisition proposal. As an early Delaware Chancery Court decision explained, the board's duty to obtain the best price does not require the board to place the firm's assets on the auction block.²⁷⁹ A Ninth Circuit decision was equally explicit: "[T]he Corporate Code of California does not adopt the auction model in regulating negotiated acquisitions."²⁸⁰ As

276. *Revlon*, 506 A.2d at 183-84.

277. *Id.* at 178.

278. See, e.g., *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 886-87 (6th Cir. 1986); *Samjens Partners I v. Burlington Indus., Inc.*, 663 F. Supp. 614, 623-24 (S.D.N.Y. 1987); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1988); *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770 (Del. Ch. 1988); *In re Holly Farms Corp. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,181, at 91,643 (Del. Ch. Dec. 30, 1988). See generally Gilson & Kraakman, *What Triggers Revlon?*, 25 WAKE FOREST L. REV. 37 (1990).

279. *Bowling v. Bonneville, Ltd.*, No. 1688, slip op. (Del. Ch. Jan. 14, 1963), reprinted in 2 DEL. J. CORP. L. 162, 169 (1977). See also *Repairman's Service Corp. v. Nat'l Intergroup, Inc.*, No. 7811, slip op. (Del. Ch. Mar. 15, 1985), reprinted in 10 DEL. J. CORP. L. 902 (1985); *Simkins Indus., Inc. v. Fibreboard Corp.*, No. 5369, slip op. (Del. Ch. July 28, 1977), reprinted in 3 DEL. J. CORP. L. 144, 146 (1977). But cf. *Thompson v. Enstar Corp.*, 509 A.2d 578, 583 (Del. Ch. 1984) (upholding a lock-up in large part because "sufficiently adequate efforts [were made] to seek other offers" and noting that it might have been invalidated had another firm offer emerged).

Thomas v. Kempner, Nos. 4138 & 4174, slip op. (Del. Ch. Jan. 5, 1977), reprinted in 5 DEL. J. CORP. L. 131 (1980), is sometimes regarded as an exception to this apparent majority view. That case, however, is more properly regarded as a forerunner of the *Revlon* decision. *Thomas* was a Multiple Bidder case in which the target's agents failed to negotiate with prospective buyers other than the favored bidder despite receiving at least two other higher offers. As such, it does not squarely stand for the proposition that directors must shop the company in Single Bidder transactions. *Smith v. Van Gorkom*, 488 A.2d 578 (Del. 1984) (en banc), is also consistent with the majority view, because it did not require that the company be auctioned in order to satisfy the duty of due care.

280. *Jewel Cos. v. Pay Less Drug Stores N.W., Inc.*, 741 F.2d 1555, 1562 (9th Cir. 1984).

courts struggled to develop general rules governing *Revlon's* scope, however, a standard emerged that threatened to extend *Revlon* duties to negotiated acquisitions.

Until recently, post-*Revlon* Delaware decisions generally held that a proposed transaction triggers the auctioneering duty when (but apparently only when) the transaction will result in a change of control of the target corporation. Most of these cases arose in connection with defensive recapitalizations. In a recapitalization, the target company typically pays a dividend to shareholders that consists of cash (often borrowed) and debt securities, thus reducing the post-dividend value of the target's stock to the extent of the distribution. While the process is usually rather complex, target managers, the target's employee stock ownership plan, or both, effectively receive the dividend in the form of stock, rather than cash or debt, at an exchange rate based on the stock's post-dividend value.²⁸¹ Alternatively, the target may conduct a tender offer in which public shareholders exchange their stock for cash and debt.²⁸² In either case, management's equity interest increases substantially vis-à-vis public shareholders.

A number of lower courts held that when a recapitalization transfers effective voting control to target management, the transaction constitutes a change in corporate control triggering *Revlon's* auction duty:

It seems unreasonable to conclude that the Delaware Supreme Court would limit the applicability of the duties of *Revlon, Inc.* to only those situations involving the complete sale of all shares of the company. Indeed, the Court of Chancery has recognized that the directors of a company have an obligation to maximize the amount received by shareholders once it is clear to them that the "corporation is to be subject to a change of control."²⁸³

281. *E.g.*, *Black & Decker Corp. v. American Standard, Inc.*, 682 F. Supp. 772, 782 (D. Del. 1988); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1343 (Del. 1987); *Robert M. Bass Group, Inc. v. Evans*, 552 A.2d 1227, 1243 (Del. Ch. 1988).

282. *E.g.*, *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 112 (Del. Ch. 1986).

283. *Black & Decker*, 682 F. Supp. at 781 (quoting *Freedman v. Restaurant Assoc. Indus., Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502, at 97,218 (Del. Ch. Oct. 16, 1987)). *See also id.* at 780-84; *Robert M. Bass Group*, 552 A.2d at 1243; *cf. Ivanhoe Partners*, 535 A.2d at 1345 (*Revlon* not triggered where management ally had less than 50% voting control after defensive recapitalization). *But see City Capital Assoc. Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787, 801-03 (Del. Ch. 1988) (any steps by board to implement a defensive recapitalization in the face of an outside offer is not tested under *Revlon*, but is tested under the *Unocal* form of review).

The Delaware Supreme Court later confirmed this approach by holding that a change of control resulting from an active auction, a management buyout, or a restructuring will trigger the duty to auction control.²⁸⁴

C. EXTENDING *REVLON* FROM RECAPITALIZATIONS TO
NEGOTIATED ACQUISITIONS

Applying *Revlon* to defensive recapitalizations raises the same issue as does its application to negotiated acquisitions: defining the limits on management's ability to protect its favored proposal from competition. In a recapitalization, this issue arises when a target board uses takeover defenses, such as poison pills,²⁸⁵ to protect its restructuring plan from interference by a hostile bidder. A poison pill may play a legitimate role in the early stages of a takeover. The pill gives the target board negotiating leverage to demand a higher offer. The potential delaying effect of a pill also may give the board time to arrange and present to shareholders a more valuable alterna-

284. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1285 (Del. 1988). The apparent extension of *Revlon* to MBO transactions is particularly interesting in light of prior Delaware Chancery Court decisions which had not required a control auction in MBO transactions. See, e.g., *City Capital*, 551 A.2d at 803; *In re TW Services, Inc. Shareholders Litig.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,179 n.8 (Del. Ch. Mar. 2, 1989) (alternatives to an auction "particularly [appropriate] in the setting of a sale to an arm's-length third party"); *In re Amsted Indus. Inc. Litig.*, 521 A.2d 1104, 1112 (Del. Ch. 1988) (criticizing failure to check fairness opinion by shopping the company), *aff'd*, 567 A.2d 1279 (Del. 1989); *In re Fort Howard Corp. Shareholders Litig.*, No. 9991, slip op. (Del. Ch. Aug. 8, 1988), *appeal refused*, 547 A.2d 633 (Del. 1988) (procedures allowing for "an effective check of the market before" closing acceptable).

285. Corporations typically structure modern poison pills as rights issued as a pro rata dividend to common stockholders. A specified event, such as the acquisition of a large block of stock by a third party or the announcement of a tender offer for some threshold percentage of target shares, triggers the issue of the rights. A so-called "flip-in" poison pill gives all target company shareholders (except the prospective hostile bidder) the right to purchase additional target stock at a discount. Activation of the plan thus causes a significant dilution in the acquirer's holdings of target shares. See *Grand Metro. PLC v. Pillsbury Co.*, 558 A.2d 1049, 1051 n.2 (Del. Ch. 1988) (activation of target's flip-in pill would have reduced acquirer's equity interest in target from 85% voting power to 56.3%). A "flip-over" poison pill, on the other hand, gives target shareholders the right to purchase bidder stock at a steep discount if the bidder successfully acquires the target. The threatened dilution of the holdings of the bidder's existing shareholders deters the bidder from proceeding with a hostile takeover. To account for all possible acquisition tactics, many modern pills incorporate both flip-in and flip-over elements. For an exhaustive discussion of the evolution of pill plans and their current legality, see TAKEOVER STATUTES AND POISON PILLS, *supra* note 243, at 505-1219.

tive transaction or strategic plan.²⁸⁶ Once the best offers are on the table, however, the pill serves only to force shareholders into accepting management's proposed transaction. Because a poison pill will inflict a substantial financial injury on a bidder, it effectively precludes the bidder from going forward with the tender offer.²⁸⁷ Thus, by leaving the pill in place while a defensive restructuring goes forward, the target board can hold off the hostile bidder until it completes the transaction.

To resolve this dilemma, courts generally have permitted a board to keep a pill in place so long as the board is running an active auction or otherwise trying to obtain a better deal for the shareholders.²⁸⁸ Once the auction is over and the best possible non-coercive alternatives are on the table, however, courts have required the board to redeem the pill and permit the shareholders to choose between the available alternatives. Management thus cannot use a pill as to coerce shareholders into accepting their proposed transaction. The shareholders must be free to choose between the hostile bid and the proposed recapitalization.

Like a poison pill used to protect a restructuring, an effective lock-up precludes a disfavored bidder from going forward. A lock-up, in fact, arguably goes further by directly coercing shareholders into approving the favored bidder's proposal. Accordingly, opponents of lock-ups and exclusivity provisions argue that, if *Revlon* forbids a target board from using a poison pill to force shareholders to accept a defensive recapitalization,

286. *City Capital Assoc. Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787, 795 (Del. 1988). See also *CRTF Corp. v. Federated Dep't Stores*, 683 F. Supp. 422, 441-43 (S.D.N.Y. 1988).

287. *City Capital*, 551 A.2d at 795.

288. *E.g., id.* at 799-800; *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 113 (Del. Ch. 1986). The Delaware Supreme Court recently cast considerable doubt on the validity of these decisions, by observing that a fair cash any or all tender offer could create a threat to corporate policy justifying defensive responses under *Unocal*. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1152-53 (Del. 1989). Some commentators have therefore seen *Time* as validating the "just say no" defense, in which management does not propose a white knight merger, management buyout or restructuring, but instead simply refuses to redeem the pill in an attempt to remain independent without any structural change in the corporation. See Hilder, *Delaware Court Explains Action on Time Merger*, Wall St. J., Feb. 28, 1990, at A3, col. 1. See generally R. GILSON & R. KRAAKMAN, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 377-83 (Supp. 1989); Gilson, *Just Say No to Whom?*, 25 WAKE FOREST L. REV. 121 (1990). Indeed, a number of targets have already relied on the *Time* decisions in rejecting hostile takeover bids. See *The "Buzz-Off" Defense: A Play on the Time Ruling*, 24 MERGERS & ACQUISITIONS, Mar.-Apr. 1990, at 7-8.

Revlon also should prohibit target board use of lock-ups and exclusivity provisions to force shareholders into approving a negotiated acquisition. As the following section demonstrates, however, the Delaware courts recently refused to extend *Revlon* to negotiated acquisitions.

D. THE DUTY TO AUCTION CONTROL AND NEGOTIATED ACQUISITIONS

On its facts, the *Revlon* duty applied only to initially hostile acquisitions in which the target board had decided to sell the company to one of several competing bidders. Subsequent cases made it clear that, at a minimum, a change of control was necessary to trigger the *Revlon* duty. The question remained whether *Revlon* applied to some or all forms of negotiated acquisitions.

Extending *Revlon* to negotiated acquisitions would have significantly changed the way target boards negotiate proposed Single Bidder transactions. Courts presumably would require a target board to shop the corporation among several competing bidders, or at least to advertise its availability, before entering a merger agreement (whether exclusive or not). Moreover, the manner in which the board conducted the bidding process, including the grant of lock-ups and exclusivity provisions to the favored bidder, would have to pass muster under the stringent standards of the modified *Unocal* test adopted in *Revlon*'s progeny. Given the rigor with which courts applied this test in some post-*Revlon* decisions, it was doubtful whether many bid-preclusive tactics would survive judicial scrutiny. Accordingly, whether *Revlon* duties extended to negotiated mergers remained the critical open question.

In its *Revlon* decision, the Delaware Chancery Court gave qualified support to a limited interpretation of the auction duty by stating that when "there is only one genuine bidder in the picture and there is a risk of losing his participation in a fast-moving situation, the quick action of directors in granting an option on substantial corporate assets will not be second-guessed under the business judgment rule."²⁸⁹ Similarly, albeit in dicta, the chancery court later suggested that *Revlon* does not require a target board to conduct an auction before validly entering a corporate merger agreement.²⁹⁰ A federal district

289. *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1250 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986).

290. *City Capital Assoc. Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787, 802

court added further support for a limited application of *Revlon* by squarely holding that a target board can enter an exclusive merger agreement with the only bidder to have placed an offer on the table without triggering *Revlon*.²⁹¹ Specifically, the court found that the directors need not delay the transaction to allow for competing bids, and that subsequent offers did not affect the validity of the agreement.²⁹²

Despite this precedent, concern that courts would ultimately extend *Revlon* to negotiated Single Bidder acquisitions led many target boards to conduct a voluntary control auction when they received an unsolicited, but more or less friendly, takeover proposal.²⁹³ Indeed, one leveraged buyout specialist

(Del. Ch. 1988) (dictum). See also *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1285 n.35 (Del. 1988) (not every corporate transaction triggers *Revlon*); *Braunschweiger v. American Home Shield Corp.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,779, at 94,192 (Del. Ch. Oct. 26, 1989) (explaining that *Revlon* does not require an auction whenever company is sold, but does require directors to probe for alternatives and have a reasonable basis for concluding that the transaction is the best available option); *In re TW Services, Inc. Shareholders Litig.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,179 n.8 (Del. Ch. Mar. 2, 1989) ("alternatives to an auction for collecting the information that directors need to make an informed choice may be appropriate"); *In re Amsted Indus., Inc. Litig.*, No. 8224, slip op. (Del. Ch. Aug. 24, 1988) (1988 Del. Ch. LEXIS 116) (alternatives to auction procedures acceptable in MBO transactions), *aff'd*, 567 A.2d 1279 (Del. 1989); *In re Fort Howard Corp. Shareholders Litig.*, No. 9991, slip op. (Del. Ch. Aug. 8, 1988) (pre-closing market test provisions satisfied *Revlon* duties), *appeal refused*, 547 A.2d 633 (Del. 1988); cf. *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 844-45 (Del. 1987) (*Revlon* inapplicable to cash-out merger in which majority shareholder obtained sole ownership over subsidiary target corporation); *Kleinhandler v. Borgia*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,525, at 93,326 (Del. Ch. July 7, 1989) (*Revlon* inapplicable where major stockholder acquires entire company); *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,710-15 (Del. Ch. Jan. 31, 1989) (upholding, under the business judgment rule and under *Revlon*, target's decision to accept one of two bids submitted in a voluntary control auction without conducting further bidding), *appeal refused*, 556 A.2d 1070 (Del. 1989); *Yanow v. Scientific Leasing, Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,660, at 98,034 (Del. Ch. Feb. 8, 1988) (holding that manner in which voluntary control auction conducted "a matter of director judgment"). The Delaware Chancery Court's dicta was noteworthy mainly because it later adopted the change in control trigger. See *Paramount Communications, Inc. v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,277 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989); *Freedman v. Restaurant Assoc. Indus., Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502, at 93,218 (Del. Ch. Oct. 16, 1987).

291. *Hastings-Murtagh v. Texas Air Corp.*, 649 F. Supp. 479, 484-85 (S.D. Fla. 1986).

292. *Id.* at 485.

293. Landefeld, *supra* note 232, at S2, col. 1.

estimated that approximately half of all transactions considered by his firm involved a control auction, with a majority of the remainder involving some element of competition.²⁹⁴ *Paramount Communications, Inc. v. Time, Inc.*,²⁹⁵ however, should slow or reverse this trend.

Although the *Time* facts are somewhat unusual, the transaction basically typifies the types of acquisitions with which this Article is concerned. Time's board of directors began searching for joint venture or acquisition opportunities with three strategic goals in mind: to develop video production capabilities; to expand its access to global markets; and to maintain Time's allegedly distinctive corporate culture.²⁹⁶ To further those ends, Time entered an exclusive merger agreement with Warner Communications. The proposed merger offered Warner shareholders newly issued Time shares representing approximately sixty-two percent of the shares of the combined entity.²⁹⁷

To discourage any effort to upset the transaction,²⁹⁸ the respective boards simultaneously approved a Share Exchange agreement that gave each party the option to trigger an exchange of shares. If either party triggered the option, Warner would receive shares representing 11.1% of Time's outstanding stock, and Time would receive shares representing 9.4% of Warner's outstanding stock.²⁹⁹ In addition, the merger agreement contained a no-shop provision and Time obtained commitments from various banks that they would not finance a takeover bid for Time.³⁰⁰

Shortly before the Time shareholders were to vote on the proposed merger, Paramount made a cash tender offer for Time. The Time board rejected the offer as inadequate, refusing to enter negotiations with Paramount.³⁰¹ In response to the Paramount tender offer, Warner triggered the share exchange

294. *Friendly Bidding Wars*, 23 MERGERS & ACQUISITIONS, Nov.-Dec. 1988, at 64, 70.

295. 571 A.2d 1140 (Del. 1989), *aff'd* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989).

296. *Paramount Communications, Inc., v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,267 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989).

297. *Id.* at 93,267-70.

298. *Id.* at 93,270.

299. *Id.*

300. *Id.* at 93,270-71.

301. *Id.* at 93,271-72. Paramount later raised its offer, which again was rejected outright. *Id.* at 93,275.

option.³⁰² Also in response to the Paramount offer, the Time and Warner boards restructured the transaction to eliminate the need for Time shareholder approval. Under the new plan, Time would make a cash tender offer for a majority block of Warner shares, and then would acquire the remaining Warner shares through a clean-up merger.³⁰³ Following unsuccessful litigation to enjoin the share exchange and Time's tender offer, Paramount withdrew its tender offer and Time's offer successfully went forward.³⁰⁴

Time raised a number of critical issues. First, did the Time board's conduct trigger the *Revlon* duties? There were at least three possible triggering events: the original decision to merge with Warner, the subsequent decision to effect the transaction as a tender offer, or the decision to grant a no-shop clause and a lock-up to Warner. Second, if none of these events obliged the Time directors to assume an auctioneering role, what standard of review applied to the Time board's favorable treatment of Warner: the traditional business judgment rule or the intermediate standard first adopted in *Unocal*? Finally, to the extent the *Unocal* intermediate standard was applicable, what constituted a legally cognizable threat to corporate policy, and were the Time board's defensive actions reasonable in relation to those threats?

For somewhat different reasons both the Delaware Chancery Court and the Delaware Supreme Court concluded that the *Revlon* duty did not apply to the original merger agreement with Warner. The chancery court, applying the change in control trigger,³⁰⁵ determined that the Time-Warner merger agreement would not result in the requisite transfer of control:

Surely under some circumstances a stock for stock merger could reflect a transfer of corporate control. That would, for example, plainly be the case here if Warner were a private company. But where, as here, the shares of both constituent corporations are widely held, corporate control can be expected to remain unaffected by a stock for stock merger. . . . Control of both [firms] remained in a large, fluid, changeable and changing market. . . .

The shareholders of Time would have "suffered" dilution, of course, but they would suffer the same type of dilution upon the pub-

302. *Id.*

303. *Id.* at 93,273-75.

304. Hilder & Landro, *Paramount Withdraws its Hostile Offer as Time Begins its Purchase of Warner*, Wall St. J., July 25, 1989, at A3, col. 1.

305. *Paramount Communications, Inc., v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,279 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989).

lic distribution of new stock.³⁰⁶

Thus, even though the former shareholders of Warner were to receive a premium for their shares and would constitute the majority of the combined firm's shareholders, the original decision to merge did not trigger *Revlon*.

The chancery court's decision left open several questions. For example, does *Revlon* apply to negotiated mergers in which the target's shareholders are to receive solely cash or debt securities for their shares?³⁰⁷ Similarly, is a change of control present when the transaction is structured as a triangular merger, in which the target company ends up as a wholly-owned subsidiary of the acquirer? When the favored bidder is publicly held, one could argue that ultimate control rests in the hands of a diverse pool of market investors both before and after the transaction, and thus *Revlon* does not apply. Prior cases in which courts found *Revlon* applicable support this argument because, with the exception of auctions triggered by a proposed defensive merger with a white knight, those cases were largely limited to management buyouts and defensive restructurings. The former category necessarily involves the elimination of public ownership. The latter also typically involves a transfer of control from public investors to corporate insiders or their allies. Both therefore involve the creation of a large block of stock held by an identifiable control group. In contrast, when

306. *Id.* at 93,279-80. Chancellor Allen also rejected plaintiffs' argument that the acquisition of Warner precluded a future acquisition of Time-Warner in which former Time shareholders might receive a premium for their shares and, accordingly, triggered the *Revlon* duties. *Id.* at 93,280-81. For a useful discussion of Allen's analysis, see Gilson & Kraakman, *supra* note 278, at 46-58.

307. It is noteworthy that Chancellor Allen subsequently held that *Revlon* does not require an auction whenever the corporation is to be sold, but does require that the directors take reasonable steps to probe for alternatives and have a reasonable basis for concluding that the favored bidder's offer is the best available alternative. *Roberts v. General Instrument Corp.*, [1990] Fed. Sec. L. Rep. (CCH) ¶ 95,465, at 97,405-407 (Del. Ch. Aug. 13, 1990); *Braunschweiger v. American Home Shield Corp.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,779, at 94,192 (Del. Ch. Oct. 26, 1989). *See also* *Rand v. Western Airlines, Inc.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,751, at 94,052 (Del. Ch. Sept. 11, 1989) (Berger, V.C.) (suggesting that *Revlon*'s principles require judicial scrutiny of a lock-up and no-shop provision granted in a negotiated Single Bidder merger for partial cash consideration). Query whether this requirement of scrutiny survives the Delaware Supreme Court's determination that the original decision to merge with Warner was subject to review solely under a business judgment rule analysis. *See Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1151-52 (Del. 1989), *aff'g* [1989 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,470 (Del. Ch. July 14, 1989).

the acquirer is publicly held, ultimate voting control before and after the acquisition rests in the hands of the acquirer's public shareholders. Control of the combined entity thus remains "in a large, fluid, changeable and changing market."³⁰⁸

On the other hand, the chancery court's reliance on the fact that the existing Time shareholders merely suffered dilution of their voting power permits an argument that a change of control occurs, and *Revlon* therefore applies, when target shareholders are entirely bought out. This interpretation, however, is contrary to the well-developed pre- and post-*Revlon* precedent and dicta that rejects application of an auctioneering duty to negotiated mergers. Moreover, if transaction planners knew that they could avoid *Revlon* by structuring a negotiated acquisition as a stock for stock merger, rather than as a triangular acquisition or a two-party merger with cash or debt consideration, evading the duty to auction control would be a simple matter indeed.

Because of the Delaware Supreme Court's holding on review, however, the Delaware courts may never resolve this potentially interesting debate. On review, the Delaware Supreme Court indicated that the chancery court's change of control analysis was correct "as a matter of law." The supreme court, however, rejected on "broader grounds" Paramount's claim that Time's board had violated the *Revlon* duty to auction control.³⁰⁹ Indeed, it appears that the supreme court used *Time* as a vehicle for sharply limiting *Revlon*'s scope:

Under Delaware law there are, generally speaking and without excluding other possibilities, two circumstances which may implicate *Revlon* duties. The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company. However, *Revlon* duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction also involving the breakup [sic] of the company.³¹⁰

308. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,280. Of course, Allen's test would pose some line drawing problems in distinguishing between cases in which an identifiable control block exists and those in which control remains in the hands of a diffuse aggregate of market investors. See R. GILSON & R. KRAAKMAN, *supra* note 288, at 385-88. For example, in a triangular acquisition, the target will be controlled by an identifiable entity — the acquiring corporation, acting through its board of directors — but control ultimately resides (at least in theory) in the hands of the diverse pool of acquiring company shareholders and thus in the market.

309. *Time*, 571 A.2d at 1150.

310. *Id.* (citations omitted).

This passage is not exactly a model of judicial clarity. Among other things, what are the other *Revlon*-triggering possibilities that the supreme court declined to exclude? If the chancery court's approach was correct as a matter of law, does the change of control trigger remain the touchstone for applying the *Revlon* duties? Or is *Revlon* only applicable if the transaction involves a break-up of the target company? What the court means by a "break-up" of the target also is not entirely clear. Presumably, the court had in mind the species of transactions commonly referred to as "bust-up" takeovers, in which a bidder finances the transaction through highly leveraged debt securities and then sells substantial portions of the target's assets to help finance the acquisition.³¹¹ The court, however, nowhere defines "break-up" — a most curious and potentially troubling omission. In sum, the court further obscured a body of law in which certainty was already a rare commodity.

Despite the unusually murky nature of the court's analysis, parties to a negotiated acquisition should take comfort from *Time*. The supreme court squarely held that the original decision to merge with Warner did not trigger the *Revlon* duties, but was subject solely to a *Van Gorkom*-type business judgment rule analysis.³¹² Moreover, the court explicitly premised its rejection of plaintiffs' *Revlon* claims on the ground that the Time board, in negotiating with Warner, did not make the dissolution or breakup of the corporate entity inevitable.³¹³ Although the facts of *Time* were somewhat unusual, the court's holding implies that only those negotiated acquisitions that contemplate breaking-up the target will trigger *Revlon*. This limitation apparently applies even though the negotiated acquisition results in a change of control under the chancery

311. See Lipton, *supra* note 179, at 11; cf. Tomczak v. Morton Thiokol, Inc., [1990] Fed. Sec. L. Rep. (CCH) ¶ 95,327, at 96,586-587 (Del. Ch. Apr. 5, 1990) (*Revlon* not triggered where company sold one of four divisions, as sale did not involve a break-up of the seller).

312. Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1152 (Del. 1989), *aff'd* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989).

313. *Id.* at 1150. The court's reference to "dissolution or break-up" may suggest that *Revlon* would apply to negotiated acquisitions structured as a sale of substantially all assets followed by a liquidation of the target. Because an asset sale also usually contemplates the end of the target's continued existence, this interpretation might be buttressed by the court's subsequent observation that when "the board's reaction to a hostile tender offer is . . . not an abandonment of the corporation's continued existence, *Revlon* duties are not triggered." *Id.* Nevertheless, this interpretation needlessly elevates form over substance and probably will not take hold.

court approach. It also would seem to be true even if *Revlon* still applies to a white knight bid, made in response to a hostile takeover proposal, that does not contemplate a break-up of the target.

Both the Delaware Chancery Court and the Delaware Supreme Court also concluded that the recasting of the acquisition as a tender offer did not trigger *Revlon*. Rather, the courts viewed the revised transaction as a defensive response subject to the *Unocal* standard of review.³¹⁴ Under the *Unocal* standard, the Time board had to identify a cognizable threat to corporate policy posed by Paramount's offer and demonstrate that its actions were a reasonable response to that threat. Paramount seemingly had a strong argument as to both issues. As we saw, earlier Delaware Chancery Court decisions had sharply limited the use of a poison pill to protect management-sponsored recapitalizations. Those cases had recognized only structural coercion and inadequate value as cognizable threats to corporate policy.³¹⁵ Moreover, when a hostile offer was non-coercive and at a substantial premium, courts had deemed defensive tactics which precluded shareholders from accepting the offer an excessive response to the minimal threat of inadequate value.³¹⁶

The chancery court distinguished the Time-Warner merger

314. Chancellor Allen rejected Time's argument that the tender offer should be analyzed under "the same business judgment form of review" utilized in *Crouse-Hinds v. InterNorth, Inc.*, 634 F.2d 690 (2d Cir. 1980), concluding that *Unocal's* intermediate level of scrutiny provided the correct approach. *Paramount Communications, Inc., v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,282 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989). Chancellor Allen also rejected Paramount's argument that the tender offer for Warner violated the rule that otherwise lawful "manipulation of the corporate machinery for the accomplishment of inequitable purposes will not be countenanced." *Id.* at 93,281-82.

315. See generally R. GILSON & R. KRAAKMAN, *supra* note 288, at 267-69 (discussing cognizable threats to corporate policy). Two-tier tender offers are the most commonly recognized form of structural coercion. In a two-tier offer the bidder announces a partial tender offer and, at the same time, announces that if the offer succeeds it will effect a back-end merger to freeze-out the remaining shareholders. The back-end merger is typically at a lower price and/or in a different type of consideration (such as junk bonds instead of cash). If shareholders believe that the offeror is likely to obtain a controlling interest in the front-end transaction, they face the risk that they will be squeezed out in the back-end for less desirable consideration. Thus, they are coerced into tendering into the front-end to avoid that risk, even if they believe the front-end transaction itself is undesirable. See Lipton, *supra* note 179, at 18-20.

316. See, e.g., *Grand Metro. Pub. Ltd. v. Pillsbury Co.*, 558 A.2d 1049, 1060 (Del. Ch. 1988); *City Capital Assoc. Ltd. Partnership v. Interco, Inc.*, 551 A.2d

from those cases. The court found that Time's long-term business plan motivated the Time board's original decision to merge with Warner.³¹⁷ The court also found that the revised transaction, while a reaction to Paramount's bid, was principally intended to facilitate that policy.³¹⁸ Because the defensive revisions arose out of preexisting, legitimate, non-defensive business considerations, the Time board had a "legally cognizable interest" in going forward with the acquisition of Warner.³¹⁹

In applying the second prong of the *Unocal* analysis, the chancery court evaluated, among other things, the importance of the corporate policy at stake and the impact of the board's actions. With respect to the first point, the court reiterated its view that pursuing the board's long-term strategy was a legitimate and important corporate goal.³²⁰ As to the latter consideration, the court observed that the offer for Warner "was effective, but not overly broad,"³²¹ because Time's acquisition of Warner did not legally preclude "the successful prosecution of a hostile tender offer" for the resulting combined entity.³²² The Time board thus "did only what was necessary to carry forward a preexisting transaction in an altered form."³²³

On review, the Delaware Supreme Court again affirmed the chancery court's holding on broader grounds. It expressly rejected Paramount's argument, based on the prior chancery court poison pill decisions, that the only threats cognizable under *Unocal* were structural coercion and inadequate value. Among the threats the court identified as justifying the Time board's response were the risk that shareholders might incorrectly value the benefits of sticking with management's long-term business plan, the difficulty of comparing Paramount's bid to the benefits of the Warner acquisition, and the possibility that Paramount's bid might "upset, if not confuse," the shareholder vote.³²⁴

The supreme court further found that the Time board's re-

787, 790-91, 799-800 (Del. Ch. 1988); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 114 (Del. Ch. 1986) (Allen, C.).

317. *Time*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 93,283.

318. *Id.*

319. *Id.*

320. *Id.* at 93,284.

321. *Id.*

322. *Id.* Chancellor Allen hinted that defensive tactics used against a hostile offer by Paramount or some other bidder for the combined entity after Time's acquisition of Warner might not be permissible. *See id.* at 93,284 n.22.

323. *Id.* at 93,284.

324. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1153

casting of the transaction was a reasonable response to these threats. Rejecting any inference that directors are obliged to abandon a pre-existing business plan to permit short-term shareholder gains, the court implied that a defensive response is unreasonable only if it is intended to coerce shareholders into accepting management's proposals. Because Time's plan was "not aimed at 'cramming down' on its shareholders a management-sponsored alternative, but rather had as its goal the carrying forward of a preexisting transaction in an altered form" and "did not preclude Paramount from making an offer for the combined Time-Warner company," those actions were both reasonable and proportionate in light of the threat posed by Paramount.³²⁵

Both the chancery court and the supreme court also held that the exclusivity provisions and lock-up designed to ward off competing bidders did not trigger *Revlon*.³²⁶ One could, however, fairly read the chancery court's opinion as requiring exclusivity provisions and lock-ups to pass muster under some variant of the *Unocal* test, even in a negotiated Single Bidder acquisition. In dictum, the Delaware Supreme Court confirmed that such "structural safety devices . . . are properly subject to a *Unocal* analysis."³²⁷ Although Paramount did not directly raise the question, the supreme court strongly implied that the lock-up option was valid because the parties adopted it to prevent Time and Warner from being "put in play," and it predated any competing bids.³²⁸ The supreme court also indicated that the no-shop clause was valid because the Time board granted the no-shop clause at Warner's insistence and for Warner's protection.³²⁹

Application of *Unocal*-like standards in this context thus should not create significant obstacles to the erection of bidding deterrents. Indeed, *Time* creates a fairly clear road map for directors to follow. They need merely prove that they had reasonable grounds for believing that competing bids posed a danger to corporate policy and that the bidding deterrents they erected were a reasonable response to that danger.³³⁰

(Del. 1989), *aff'd* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989).

325. *Id.* at 1154-55.

326. *Id.* at 1151.

327. *Id.*

328. *See id.* at 1151 n.15.

329. *Id.*

330. *See id.* at 1152.

As to the first *Unocal* prong, a target board is under no obligation to maximize the immediate value of the corporate shares unless the proposed transaction triggers the *Revlon* duty.³³¹ Rather, the board is free to reject the immediate value presented by a competing bid in the hope that its long-term strategic plan will produce greater future value. Accordingly, in cases like *Time*, to produce the requisite corporate policy target boards need merely cobble together a plausible strategic plan (preferably as far ahead of time as possible) and claim that the peculiar synergies created by a merger with the favored bidder are part of achieving that plan. In turn, the risk of competing bids should create the requisite threat, because every competing bid creates a risk that shareholders will reject management's long-term plans in favor of the short-term gains available from the competing bidder. Alternatively, in many acquisition settings, competing bids will often interfere with the shareholder vote on the favored bidder's proposal and potentially confuse shareholders. Because *Time* recognized these possibilities as cognizable threats to corporate policy,³³² *Time* significantly eased the burden imposed by the first *Unocal* prong.

As to the second *Unocal* prong, exclusivity provisions and lock-ups should routinely pass muster after *Time*. Competent transaction planners will have little difficulty creating a paper trail presenting justifications for exclusivity provisions and lock-ups comparable to those cobbled together by *Time* and *Warner*. Bidding deterrents adopted before a competing bid emerges, intended to carry forward the preexisting favored bidder transaction, and not legally precluding a successful takeover of the surviving combined entity, likely will be upheld as reasonable and proportionate responses to the threat posed by competing bids.³³³

In summary, *Time* marks a major turning point in the evolution of both *Unocal* and *Revlon*. Both the chancery court and supreme court significantly expanded the list of cognizable threats to corporate policy recognized under the *Unocal* stan-

331. *Id.* at 1154.

332. *Id.* at 1153.

333. *See id.* at 1151-52, 1154-55. On the other hand, it may still be possible to argue that the coercive nature of effective lock-ups renders them invalid under the second *Unocal* prong. *See id.* at 1154 ("management actions that are coercive in nature or force upon shareholders a management-sponsored alternative to a hostile offer may be struck down as unreasonable and nonproportionate responses").

dard. Both courts also limited the class of transactions triggering *Revlon's* auctioneering duty. Specifically, they refused to apply *Revlon* to negotiated mergers — even those protected by exclusivity provisions or lock-ups — unless the acquisition contemplates selling off substantial portions of the target. If no break-up will result, the parties need only comply with the *Van Gorkom* requirements, supplemented by a greatly weakened *Unocal* standard, to validly enter exclusivity provisions and lock-ups.

IV. A PROPOSED FRAMEWORK FOR ANALYZING EXCLUSIVITY PROVISIONS AND LOCK-UPS

The *Time* courts correctly refused to extend *Revlon* to negotiated acquisitions not involving a break-up of the target. Forcing unwilling directors to conduct an effective auction is extremely difficult. More importantly, management often has legitimate reasons not to affirmatively auction the company. Many bidders simply refuse to act as a stalking horse for the target corporation.³³⁴ Other potential bidders may be unwilling to invest in the necessary up-front costs if they must participate in an auction.³³⁵ The litigation and adverse publicity that likely will accompany an auction may deter still other potential bidders.³³⁶ If the target board nevertheless auctions the corporation, the initial bidder's willingness to pay a high premium for the target may dissipate if another bidder does not come forward. In light of these considerations, the target board could rationally and in good faith decide that a control auction would

334. *E.g.*, *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 270-71 (2d Cir. 1986); *Samjens Partners I v. Burlington Indus., Inc.*, 663 F. Supp. 614, 625 (S.D.N.Y. 1987); *Keyser v. Commonwealth Nat'l Fin. Corp.*, 644 F. Supp. 1130, 1146-47 (M.D. Pa. 1986); *Hecco Ventures v. Sea-Land Corp.*, No. 8486, slip op. (Del. Ch. May 16, 1986), *reprinted in* 12 DEL. J. CORP. L. 282, 287 (1987).

335. *See Helman & Davis, supra* note 6, at 11. Most commentators concur that exclusivity provisions are often necessary inducements for an offer, especially in the Single Bidder context. *See, e.g.*, *Johnson & Siegel, supra* note 9, at 410; *Nachbar, supra* note 14, at 481-83; Note, *Merger Contracts, supra* note 3, at 757; Note, *Down But Not Out — The Lock-Up Option Still Has Legal Punch When Properly Used, supra* note 164, at 1153-54; Note, *Lock-Up Options, supra* note 34, at 1078. *But see Buxbaum, supra* note 4, at 1705; *Oesterle, supra* note 1, at 151-53.

336. It has become routine for at least one of the contending parties to seek judicial review of a takeover contest. *See R. GILSON, supra* note 92, at 642-52. In addition, public mud-slinging by some or all of the contestants is not uncommon. *See generally id.* at 658-66 (noting adverse publicity likely to accompany auction of control).

be detrimental to the shareholders' best interests. Insisting that directors always shop the company risks losing the bird in hand with no guarantee that one can be found in the bushes.

On the other hand, the *Time* courts went too far in allowing target directors to erect bidding deterrents in cases where some long-term strategic plan purportedly justifies protecting the favored bidder's proposal from competition. As Part II demonstrated, competitive bidding (or, more accurately, the threat of a competing bid) is the best available constraint on the potential conflict of interest inherent in negotiated corporate acquisitions. Although the *Time* courts apparently would not give management free rein to erect bidding deterrents, the weakened *Unocal*-type analysis they mandate is unlikely to be an effective check on management misconduct. Like the traditional power and duty of care approaches, the *Time* approach substitutes judicial review for market review. As such, it suffers from the same flaws as the traditional approach. Moreover, competent transaction planners should have little difficulty structuring valid exclusivity provisions and lock-ups under the weakened *Unocal* standard.³³⁷ Accordingly, if subsequent courts ultimately interpret *Time* as generally permitting bid-detering exclusivity provisions and lock-ups in Single Bidder acquisitions, a likely occurrence,³³⁸ *Time* will significantly reduce the effectiveness of competitive bidding as a check on self-interested behavior by target management.

To strike an appropriate balance between the need to enable directors to make decisions in the best interests of shareholders and the need to prevent target board self-interested behavior, courts should adopt a position between *Revlon* and *Time*. There is an important difference between a duty to affirmatively shop the company and a duty that simply prevents the board from taking steps that will effectively preclude competitive bidding. A *Revlon*-style control auction after all is only necessary because, in the multiple bidder context, any decision by the target board to prematurely favor one bidder raises suspicion of self-interested behavior.³³⁹ In transactions where a conflict of interest between target management and shareholders is less likely, the board need not actively auction the com-

337. See *supra* notes 326-32 and accompanying text.

338. See text accompanying notes 225-333 (Part III).

339. At bottom, this was *Revlon*'s main point. The control auction mandated by *Revlon* arguably was not intended to maximize shareholder wealth, but to constrain self-interested behavior by management.

pany so long as it does not take steps that foreclose competing bids. This approach assures that the transaction is at least open to meaningful market review.

Thus, rather than imposing a duty to affirmatively shop the company in all cases, courts should focus on whether the target board's conduct precludes competitive bidding. Because lock-ups have a greater deterrent impact on competitive bidding than exclusivity provisions, this Article proposes that courts require target boards to comply with a more stringent standard of conduct before they will validate lock-ups than is required to validate exclusivity provisions.³⁴⁰

A. JUDICIAL REVIEW OF EXCLUSIVITY PROVISIONS

In the Single Bidder context, a control auction need not precede the granting of exclusivity provisions. As we have seen, the target shareholders often have a strong interest in assuring that the initial bidder's proposal is successful — an interest that exclusivity provisions may do much to promote.³⁴¹ At the same time, exclusivity provisions do not significantly impede competitive bidding.³⁴² Rational target managers must know that in today's takeover environment these provisions provide weak security for side payments offered by bidders. Side payments, therefore, likely do not prompt target boards to enter exclusivity provisions. A more plausible assumption is that management grants exclusivity provisions out of a real belief that doing so is in the best interests of the shareholders. As such, a modified version of the duty of care approach is appropriate for performance promises and cancellation fees.

Judicial review of performance promises and cancellation fees should therefore proceed along the lines suggested in Part

340. The Delaware Supreme Court's holding that the "use of [a no-shop clause] is even more limited than a lock-up arrangement," *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1286 (Del. 1989), makes sense, if anywhere, only in the Multiple Bidder context. A serious risk of management self-dealing plainly exists in many Multiple Bidder cases. Absent distinguishing factors such as the form of consideration and the likelihood of consummation, a decision by the target board to enter an exclusive merger agreement containing performance promises with the lower bidder, thereby foreclosing negotiations with an existing higher bidder, necessarily raises suspicion of misconduct. The same is not true in the Single Bidder context, where there is no guarantee that a second bidder will emerge. Moreover, as described in the next Section, there are substantial policy justifications for exclusivity provisions in the Single Bidder context.

341. See *supra* notes 199-205 and accompanying text.

342. See *supra* notes 193-96 and accompanying text.

II. The initial inquiry should focus on the board's decision to grant the exclusivity provisions. Concluding that the exclusivity provision was validly granted, however, should not end the inquiry. If circumstances have materially changed since the merger agreement was signed, the board should be required to determine whether to perform or breach its obligations under the exclusivity provision.

In the first phase, plaintiff (presumably a competing bidder or a target shareholder) should bring an action against the target's board seeking an injunction precluding them from performing under the exclusivity provision and/or damages for having granted it. In light of the substantial policy arguments in favor of exclusivity provisions and the low probability in the Single Bidder context that side payments motivated the board's decision, a court should presume that the board has the authority to grant exclusivity provisions and should protect its decision with the business judgment rule. Thus, to invalidate the exclusivity provision, plaintiff must rebut the business judgment rule by showing that self-dealing or one of the other traditional bases on which the rule may be set aside tainted the board's decision to grant the provision. If the plaintiff succeeds in doing so, the court should enjoin enforcement of the exclusivity provision or grant other appropriate relief. If the plaintiff fails, the exclusivity provision remains enforceable and will support a cause of action for damages if the target board subsequently breaches the merger agreement.

A material change in circumstances, such as the emergence of a competing bid before the merger becomes effective, triggers the second phase of the inquiry. Here, plaintiff should sue the board if it fails to breach its merger agreement with the favored bidder. Although the exclusivity provision remains enforceable by a third party in an action for damages, once circumstances change the board must determine whether to perform or breach its obligations under the exclusive merger agreement in light of the changed circumstances. Central to the board's deliberations should be whether breach is efficient, which requires the board to weigh the costs of breaching against the benefits of breaching. For example, damages owed to the disappointed bidder and other litigation costs may conceivably exceed the benefits gained from breaching the agreement and accepting a higher competing offer.³⁴³ In such a case,

343. For an overview of contract damage calculations that will promote efficient breaches, see R. COOTER & T. ULEN, *supra* note 207, at 296-319. As to

the board might reasonably determine that failure to breach the agreement with the initial bidder is in the shareholders' best interests. The board may be wrong, but it is precisely this type of decision that the business judgment rule was intended to protect. As such, a plaintiff again must overcome the business judgment rule — this time with respect to the board's decision not to breach its agreement with the favored bidder — before courts can hold the board liable.

In sum, the proposal adopts elements of both *Jewel* and *Great Western*. It follows *Jewel* by holding that the board has authority to enter an exclusivity provision and that the favored bidder generally can enforce such a provision. On the other hand, it follows *Great Western* by imposing on directors a duty to reevaluate the transaction when circumstances change. A board decision to perform despite changed circumstances, however, will not result in liability unless the plaintiff can overcome the business judgment rule.

The proposal's adoption of the business judgment rule as the appropriate standard of review might be criticized on the same grounds as this Article criticized the current duty of care methodology, *i.e.*, that the business judgment rule no longer provides, if it ever did, a relatively objective standard. For example, under this proposal, courts could impose a back-end auction obligation through the requirement that the board make an informed decision. Courts could do so simply by taking the position that a failure to seek alternative offers means that the board was not fully informed when it approved the merger.

Although this Article has not attempted a full-blown evaluation of the post-*Van Gorkom* business judgment rule, it is true that *Van Gorkom* and its progeny injected substantial uncertainty into traditional business judgment rule analysis. The courts' failure to identify a clear set of standards by which directors could measure their conduct, however, mainly caused this uncertainty.³⁴⁴ This proposal therefore assumes that target boards will utilize the types of prophylactic steps approved in *Hanson Trust*,³⁴⁵ which need not include seeking alternative bids. This proposal also assumes that compliance with these prophylactic standards will insulate the board from liability un-

the specific issue of damages for breach of an acquisition agreement, see Dillport, *Breaches and Remedies*, in II BUSINESS ACQUISITIONS 1249 (J. Herz & C. Baller 2d ed. 1981).

344. See *supra* notes 130-47, 183-87 and accompanying text.

345. See *supra* note 183.

less one of the traditional exceptions to the business judgment rule (such as fraud, illegality, or self-dealing) is present. It may also be desirable for courts to limit the scope of their review by adopting the ALI's lower standard regarding the amount of information necessary for directors to make an informed decision.³⁴⁶

Of course, Delaware's new director liability statute will limit the directors' exposure to personal liability under this proposal. Assuming plaintiff could overcome the business judgment rule and could otherwise satisfy the requirements for equitable relief, however, the statute would not preclude a shareholder from obtaining an injunction against enforcement of the exclusivity provision, an injunction requiring the directors to breach the initial merger agreement, or both.³⁴⁷

This Article will not fully explore the merits of director liability statutes. The Delaware statute's effect on the incentives of target directors in this context, however, is a particularly noteworthy example of the problems created by limiting director liability. For example, suppose the merger agreement contains a best efforts clause requiring the directors to use their best efforts to obtain shareholder approval of the agreement. Breach of the exclusive merger agreement in that case might result in personal liability of the target directors to the disappointed bidder.³⁴⁸ As a result, the target directors would have an incentive not to breach. In the absence of the shield provided by the liability statute, however, the directors would have a counter-incentive to breach. If their failure to breach constituted a violation of the duty of care as to which a shareholder plaintiff could overcome the business judgment rule, directors would face potential liability for refusing to breach. The statute removes this risk. As a result, limiting director liability may make directors less likely to breach in cases where breach is efficient. Courts could counteract this incentive effect by being more receptive to requests for affirmative equitable relief or by being more willing to allow plaintiffs to recast their claims as duty of loyalty actions.³⁴⁹

346. See *supra* note 116.

347. See DEL. CODE ANN., tit. 8, § 102(b)(7) (1988); see generally *supra* note 148 (noting the states' new director liability statutes).

348. Cf. *ConAgra, Inc. v. Cargill, Inc.*, 222 Neb. 136, 156, 382 N.W.2d 576, 587 (1986) (per curiam) (declining to decide whether breach of such a best efforts clause would result in personal liability for target directors).

349. Significantly, the Delaware Supreme Court has stated that both the duty of care and the duty of loyalty were involved in *Revlon*, and that both

B. JUDICIAL REVIEW OF LOCK-UPS

A much stronger inference, if not a presumption, of self-interest exists when a target board protects a Single Bidder merger agreement through a lock-up that effectively precludes competitive bidding. Why would an agent preclude the chance of a better competing bid for his principals if not for selfish reasons? The directors presumably must feel that a competing bidder could easily trump the deal they made and that, if trumped, they and management will not receive the side payments promised by the favored bidder. True, side payments may not be present in every lock-up transaction. But it is also true that not every interested director transaction or taking of a corporate opportunity involves self-dealing. Just as in the latter contexts, the greater likelihood of self-dealing associated with lock-ups justifies more exacting scrutiny of their validity than was the case with exclusive merger agreements.

Unfortunately, whether a particular lock-up is likely to elicit or preclude new bids — the current *Revlon* standard — is something that can be known with certainty only after the fact. To avoid this problem, this Article proposes a bright-line standard dividing bid-preclusive from non-preclusive lock-ups.³⁵⁰ Like exclusivity provisions, courts should give a board's decision to grant a non-preclusive lock-up the protections of the business judgment rule. Before enforcing a bid-preclusive lock-up, however, courts should require the board to comply with an objective set of prophylactic steps. This objective standard, along with the bright-line dividing line, will provide directors with the necessary degree of ex ante certainty. Admittedly, there is some risk that this standard will be either underinclusive (allowing some bid-preclusive lock-ups to pass muster) or overinclusive (prohibiting some non-preclusive lock-ups).³⁵¹ Gains from enhanced certainty, however, should overcome these costs. In addition, this approach conserves judicial re-

had been breached. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1284 n.34 (Del. 1988). This may presage a greater willingness to allow plaintiffs to cast takeover claims generally as duty of loyalty violations, thus avoiding the liability limitations of the new statute.

350. Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offeror's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1264-65 (1984) (discussing desirability of bright-line standards for takeover defenses).

351. Cf. Erlich & Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEG. STUD. 257, 268-69 (1974) (discussing under or overinclusiveness produced by specific rules).

sources by substituting an objective standard for the subjective aspects of the *Revlon* analysis.

The principal problem is drawing the bright line dividing bid-preclusive lock-ups from non-preclusive lock-ups. Although any level is somewhat arbitrary, a threshold of ten percent of the value of the favored bidder's proposal is a reasonable compromise.³⁵² Courts have held a lock-up valued at approximately eight percent of the transaction price did not impede competitive bidding, but that a lock-up valued at approximately seventeen percent did deter an auction.³⁵³ The ten percent threshold also corresponds to the federal securities law presumption that a ten percent shareholder is a controlling person.³⁵⁴ Finally, this proposed trigger probably approximates the maximum number of shares a bidder could reasonably expect to acquire in the principal alternative to a lock-up — a stock acquisition program undertaken before the acquirer discloses its intentions.³⁵⁵ Again, it is worth stressing that however arbitrary this ten percent threshold may appear, and granting that in some cases it will not capture bid-preclusive lock-ups and in others it will allow them, the certainty it (or some comparable level) provides should ultimately outweigh the risk of under or overinclusiveness in a particular acquisition.³⁵⁶

For purposes of the bright-line standard, courts should de-

352. Fifteen percent thresholds, variously measured, also have been suggested by other commentators. See, e.g., SEC ADVISORY COMMITTEE ON TENDER OFFERS, REPORT OF RECOMMENDATIONS 44 (1983), reprinted in [Extra Ed. No. 1028] Fed. Sec. L. Rep. (CCH) (July 15, 1983) ("requir[ing] that during a tender offer the issuance of stock representing more than 15% of the fully diluted shares that would be outstanding after issuance should be subject to shareholder approval") [hereinafter SEC ADVISORY REPORT]; Johnson & Siegel, *supra* note 9, at 409-10 (proposing that stock options be limited to 15% of the target's outstanding shares and asset options to 15% of its assets). By using the value of the transaction as its yardstick, this proposal probably approximates those proposals.

353. Compare *Smith v. Pritzker*, No. 6342, slip op. (Del. Ch. July 6, 1982), reprinted in 8 DEL. J. CORP. L. 406, 415 (1983) (lock-up covered one million shares; offeror proposed to pay \$55 per share for a total value of \$690 million), *rev'd on other grounds sub nom. Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (en banc) with *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 372 (6th Cir. 1981) (lock-up covered 10 million shares; bidder proposed to pay \$125 per share in two-tier offer in which approximately 58.7 million shares would be acquired), *cert. denied*, 455 U.S. 982 (1982).

354. See R. JENNINGS & H. MARSH, *supra* note 34, at 473-74.

355. See *supra* note 31 and accompanying text.

356. Cf. Coffee, *supra* note 350, at 1265 (noting a similar point with respect to bright-line rules governing certain takeover defenses). In light of the specificity of the proposed rule, it may be necessary to adopt it through legislation. On the other hand, there is precedent for judicial rules of thumb of this sort,

fine lock-ups as including (1) all cancellation fees paid or to be paid to the favored bidder, (2) stock options, sales, or other transactions in which the target corporation issues target shares to the favored bidder,³⁵⁷ and (3) asset options or a sale of target assets to the favored bidder. Courts should calculate the value of stock lock-up options by the per share price the bidder will pay target shareholders.³⁵⁸ This valuation method obviates the need to consider the adequacy of the consideration paid for the option or for the shares issued on exercise of the option. Courts should likewise measure the value of asset lock-up options by the appraised fair market value of the assets in question.³⁵⁹

such as the control presumption in the securities laws. *See supra* text accompanying note 354.

357. A variety of state takeover laws and corporate takeover defensive tactics can be used in effect as a lock-up by waiving their application with respect to only one of several competing bidders. *See TAKEOVER STATUTES AND POISON PILLS, supra* note 265, at 28-29, 42-43, 937; 1 R. WINTER, M. STUMPF & G. HAWKINS, *SHARK REPELLENTS & GOLDEN PARACHUTES* § 3.2 at 49-50 (1983 & Supp. 1988). Under current law, a target board's decision to selectively waive a takeover statute or defense may constitute a breach of the board's fiduciary duties. *Compare City Capital Assoc. Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787, 797 (Del. Ch. 1988) (granting preliminary injunction against poison pill allegedly used to favor target's restructuring plan over competing tender offer) *with Samjens Partners I v. Burlington Indus., Inc.*, 663 F. Supp. 614, 619 (S.D.N.Y. 1987) (upholding board decision to selectively opt out of takeover statute). While the board should have discretion to use such devices as a "gavel to run an auction," *CRTF Corp. v. Federated Dep't Stores, Inc.*, 683 F. Supp. 422, 439 (S.D.N.Y. 1988), selective waivers of these devices should be prohibited where the board does not conduct an auction. *Cf. Johnson & Siegel, supra* note 9, at 407-08 (advocating a prohibition on the use of defensive tactics which deter competing bids).

358. Alternatively, courts could measure the value the bidder places on stock lock-ups by the difference between the per share exercise price and the per share price in the bidder's acquisition proposal. Although this approach appears to more accurately measure the coercive and preclusive effect of a lock-up, as a practical matter, the difference between the two standards is not significant. Either valuation approach should suffice so long as the trigger level is properly set.

359. Valuation of asset lock-ups can be a most difficult issue for the courts. The risk that the board's financial advisor will place a market value that is too low on the assets could be countered by judicial appointment of a special master (perhaps an investment banking firm not associated with either party) whose evaluation of the fair market value of the assets in question would be final for purposes of litigation. *Cf. Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 718 (Iowa 1983) (providing for appointment of "special panel" to assess merits of shareholder derivative litigation). This result is admittedly not perfect. Among other things, it is likely to increase the expense of litigation. The appointment of a special master, however, has the virtue of eliminating one of the more difficult litigation issues. It should also encourage the board's advisers to be conservative in their initial valuation efforts. Fi-

Under any valuation method, if the target board grants more than one of the specified arrangements, courts should combine the value of all the arrangements, including the value of any arrangements granted to the favored bidder's affiliates, to determine whether they exceed the trigger level. This combined value requirement is necessary to prevent evasion.³⁶⁰ For example, the target otherwise-could grant a lock-up option slightly below the ten percent trigger level and then further enhance its deterrent effect by agreeing to a large cancellation fee.

The next issue is defining the method of review courts should apply to lock-ups exceeding the threshold. One frequently proposed approach requires prior shareholder approval of lock-ups.³⁶¹ Proponents of shareholder approval requirements often justify this approach with notions of corporate democracy. Although there is a widely shared belief that shareholders should make the ultimate decisions about the company's future,³⁶² this view is neither universal nor dispositive. An important recent takeover decision stressed the board's responsibility to manage the business and affairs of the corporation in the course of permitting board actions that a ma-

nally, directors could avoid the uncertainty it produces by relying solely on stock options or shopping the company before agreeing to an asset option.

360. The combined value approach also obviates any need for assessing the reasonableness of a cancellation fee standing alone. Professors Johnson and Siegel, *supra* note 9, at 409, propose requiring prior shareholder approval of cancellation fees exceeding "reasonable expenses incurred in negotiations with the target." *Id.* at 410. In light of the problems posed by shareholder apathy and the difficulty of determining the reasonableness of a fee arrangement, this Article rejects that approach.

361. This approach recently was adopted by provisions of the British City Code with respect to defensive lock-ups. PANEL ON TAKEOVERS AND MERGERS, CITY CODE ON TAKEOVERS AND MERGERS RULE 21 (1985). *See also* SEC ADVISORY REPORT, *supra* note 352, at 44 (during a tender offer, issuance of stock representing more than 15% of the fully diluted outstanding shares should be subject to shareholder approval); R. GILSON, *supra* note 92, at 844-47 (shareholder approval of lock-ups proposed); Coffee, *supra* note 350, at 1261 (suggesting that stock exchange shareholder approval requirement for certain stock lock-ups be extended to asset lock-ups); Johnson & Siegel, *supra* note 9, at 409-13 (advocating prohibiting lock-ups unless the agreement or transaction receives prior approval by target shareholders; "Lock-Ups" are defined as (1) stock options or sales resulting in more than a 15% increase in outstanding target voting shares or (2) sales or agreements to sell more than 15% of the target's assets).

362. *See* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 276-77 (2d Cir. 1986) (ultimate decision for shareholders); Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255, 258 (2d Cir. 1984) (same); AC Acquisition Corp. v. Anderson Clayton & Co., 519 A.2d 103, 112-15 (Del. Ch. 1986) (same).

jority of the shareholders probably opposed. As the Delaware Chancery Court emphasized:

The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm. . . . That many, presumably most, shareholders would prefer the board to do otherwise than it has done does not, in the circumstances of a challenge to this type of transaction, in my opinion, afford a basis to interfere with the effectuation of the board's business judgment.³⁶³

A more sophisticated argument in favor of a shareholder approval requirement is that shareholder approval provides a necessary constraint on management.³⁶⁴ This argument also is flawed. When a competing bid does not emerge, rational shareholder apathy prevents shareholder approval from providing an effective constraint on board misconduct. Moreover, the significant costs related to shareholder approval would more than outweigh any limited benefit that did result. Although shareholders could approve lock-ups at the same time as the merger agreement, this approval method would wholly eliminate their utility. Mandating shareholder approval of lock-ups thus effectively requires two shareholder meetings, one to approve the lock-up provisions and a later one to approve the underlying merger. The considerable cost and time required to prepare and conduct a proxy solicitation means that the double meeting requirement effectively prohibits the use of lock-ups, especially in time sensitive acquisitions.³⁶⁵ Proponents of shareholder approval requirements might just as well convert this *de facto* ban into a *de jure* prohibition of lock-ups, as the end result is likely to be the same.

Consistent with this Article's general thesis that market forces most effectively constrain conflicts of interest in the acquisition setting, this part argues that an *ex ante* control auction would provide a more effective check on management's conduct. If the board wishes to grant a lock-up exceeding the ten percent trigger, courts should require the board to volunta-

363. *Paramount Communications, Inc. v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,284 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989). See also *In re TW Services, Inc. Shareholders Litig.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,180 (Del. Ch. Mar. 2, 1989) (same).

364. *E.g.*, *Johnson & Siegel*, *supra* note 9, at 411-13 (discussing the possible results and consequences of permitting only shareholder approved lock-up fees).

365. *Id.* at 413.

rily shop the company among other bidders before agreeing to the lock-up. If the target board conducts a fair auction, a preclusive lock-up becomes unobjectionable, as it is now unlikely that the favored bidder prevailed because of side payments to management. Indeed, a preclusive lock-up may prove beneficial if granted at the end of a fair voluntary auction.³⁶⁶ Among other things, target managers may be able to extract a higher price or better terms in return for the greater certainty offered by lock-ups. If the target board refuses to conduct a voluntary control auction before entering into lock-up provisions that exceed the ten percent trigger, however, courts should invalidate the provisions.

The remaining problem is to define the standards by which courts should review the auction's adequacy. Several Delaware decisions imply that courts will review control auction procedures under the business judgment rule.³⁶⁷ A traditional business judgment rule analysis, however, would create considerable opportunities for abuse because it effectively allows virtually unconstrained directorial power to conduct the auction. The board could, for example, abdicate its role by delegating responsibility for designing and executing the auction to self-interested insiders who may clandestinely skew the process in favor of one bidder.³⁶⁸ Alternatively, the board itself might conduct merely a pro forma auction. In either case, "given the human temptations left unchecked,"³⁶⁹ the salutary effects of competitive bidding would be lost.

The inherent risk that target insiders may principally pursue their own self-interest calls for strict judicial examination before courts give deference to the directors' ultimate decision. As in *Unocal*,³⁷⁰ the board should have the initial burden of proving that the auction process adopted was fair and

366. *E.g.*, *Cottle v. Storer Communication, Inc.*, 849 F.2d 570, 575-77 (11th Cir. 1988) (board granted an asset lock-up to offeror whose offer was \$16 per share higher as a result of the auction).

367. *E.g.*, *TCG Securities, Inc. v. Southern Union Co.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,928, at 95,217 (Del. Ch. Jan. 31, 1990); *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,710-15 (Del. Ch. Jan. 31, 1989), *appeal refused*, 556 A.2d 1070 (Del. 1989); *Yanow v. Scientific Leasing, Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,660, at 93,034 (Del. Ch. Feb. 8, 1988).

368. *See Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1281-82 (Del. 1989) (defendant's board of directors delegated responsibilities for overseeing sale of corporate control to selected corporate representatives who tipped the process in favor of one bidder).

369. *Id.* at 1281.

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

reasonable.³⁷¹

The target board should begin by making full public disclosure of the proposed transaction to assure that the market is fully informed that the target is for sale. The quality and timing of the disclosure should create a reasonable probability of notice to parties having sufficient sophistication and resources to bid.³⁷² Retaining an investment banker or broker to solicit bids from potential acquirers is a common and effective means of generating offers.³⁷³ Because of the additional costs of using a finder, however, the target board need not use this approach. At a minimum, however, the target board should demonstrate that the relevant players in the industry, especially entities previously expressing interest, were aware of its willingness to entertain offers.³⁷⁴

The target board also should provide responsible entities who express an interest in the target with relevant information concerning the corporation.³⁷⁵ When one bidder in an active

371. Although the reasonableness of the auction process depends on the unique facts of each case, courts should establish clear standards defining a fair auction and assure directors that compliance with these specified standards will validate their decisions. The guidelines proposed herein are based in large part on the American Law Institute's tentative rules governing MBO transactions. See CORPORATE GOVERNANCE: Draft No. 9, *supra* note 112, § 5.15. Although § 5.15 does not expressly address exclusivity provisions, they provide a workable framework from which to develop appropriate standards. For a general discussion of various current auction techniques, see Atkins, "Auction" *Law and Practice in Unsolicited Takeovers (and in Other Corporate Control Transfer Cases)*, in MERGERS & ACQUISITIONS: TODAY'S STRATEGIES AND TECHNIQUES 131 (1989).

This Article adopts the commentary to § 5.15's proposal that target shareholders should not be limited to an appraisal remedy when challenging exclusivity provisions. See *id.* at § 8. Rather, a variety of alternative remedies should be available, including enjoining the transaction or the provision in question, rescinding the transaction or damages from the directors who approved the transaction in violation of their duties.

372. See CORPORATE GOVERNANCE: Draft No. 9, *supra* note 112, at 10.

373. *E.g.*, Beebe v. Pacific Realty Trust, 578 F. Supp. 1128, 1137 (D. Or. 1984) (broker "had a real motive to market the stock with a substantial commission as a reward"). See generally Dwyer & Garner, *Finding More than a Finder*, in M. ROCK, *supra* note 2, at 127 (noting brokers often retained to solicit bids); Herz, *Broker and Finder Agreements*, in M. ROCK, *supra* note 2, at 135 (same).

374. See Yanow v. Scientific Leasing, Inc., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,660, at 93,034 (Del. Ch. Feb. 8, 1988).

375. In *Mills*, the Delaware Supreme Court set forth the following non-exclusive list of factors for "assessing the bid and the bidder's responsibility":

the adequacy and terms of the offer; its fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; the impact of both the bid and

auction receives preferential access to information, it obtains a significant competitive advantage which may irretrievably skew the bidding in its favor. Equal access to information is particularly essential when a management buyout (MBO) group is one of the bidders, because management's inside position gives it significant informational advantages.³⁷⁶ On the other hand, the target board can legitimately withhold information from a bidder if disclosure of proprietary information would injure the corporation's business and the bidder refuses to sign a confidentiality agreement.³⁷⁷

After giving remaining bidders a reasonable opportunity to submit proposals, the target's representatives should begin negotiating with each of the serious contenders. Good faith negotiations with each of the competing bidders is a critical element in showing that management did not improperly skew the process.³⁷⁸ Prompt and detailed negotiations also help the directors satisfy their duty of due care because the target's negotiating representatives can present to the board a more or less final merger agreement and full information relating to each offer.

The target board should have reasonable discretion over

the potential acquisition on other constituencies, provided it bears some reasonable relationship to general shareholder interests; the risk of non-consummation; the basic stockholder interests at stake; the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on stockholder interests.

Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1282 n.29 (Del. 1989).

376. See CORPORATE GOVERNANCE: Draft No. 9, *supra* note 112, at 5-6. In voluntary auctions, it has become common practice for prospective bidders to be given an offering document describing the target and offered a limited opportunity to meet with target management and conduct due diligence reviews before submitting their bid. Once the firm or its investment banking firm identifies several serious bidders, the surviving potential buyers are given an opportunity for more detailed due diligence review. See A. MICHEL & I. SHAKED, *supra* note 18, at 174-77; S. REED, *supra* note 14, at 447-83; Grafer & Baldasaro, *Effective Due Diligence*, in M. ROCK, *supra* note 2, at 271-80.

377. *E.g.*, Samjens Partners I v. Burlington Indus., Inc., 663 F. Supp. 614, 625 (S.D.N.Y. 1987); *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 784 (Del. Ch. 1988); *In re Fort Howard Corp. Shareholders Litig.*, No. 9991, slip op. (Del. Ch. Aug. 8, 1988), *appeal refused*, 547 A.2d 633 (Del. 1988). An appropriate confidentiality agreement would require the bidder to keep non-public information confidential and to refrain from using the information for any purpose other than making a takeover proposal. See CORPORATE GOVERNANCE PRINCIPLES: Draft No. 9, *supra* note 112, at 11.

378. Compare *Mills*, 559 A.2d at 1281 with *Hecco Ventures v. Sea-Land Corp.*, No. 8486, slip op. (Del. Ch. May 19, 1986), *reprinted in* 12 DEL. J. CORP. L. 282, 289-90 (1987).

the number of bidding and negotiating rounds.³⁷⁹ As under *Revlon*, the board also should have discretion to consider factors other than mere price in deciding which bid to accept. An all cash offer, for example, may be preferable to a nominally higher bid in which a significant part of the consideration involves high-risk securities. As is customary with mergers of public corporations, the target board should obtain an opinion from an independent financial adviser that the chosen offer is fair and adequate.³⁸⁰

Of course, the board must obtain shareholder approval of the merger with the favored bidder in accordance with the applicable statute. In doing so, the board should fully disclose any employment agreements or other arrangements between the incumbent officers, the disinterested directors, and the prevailing bidder.³⁸¹ The board also should disclose auction procedures used and the results obtained.³⁸² In addition, if an MBO group is the prevailing bidder, a majority of the disinterested directors and a majority of the disinterested shareholders should approve the transaction to further minimize the risk of abuse.

If the board fails to comply with these standards in conducting the control auction, the court should invalidate the lock-up provisions. On the other hand, if the board complies with these standards, its decision to accept one of the competing bids and to enter into a lock-up with the prevailing bidder is entitled to the protections of the business judgment rule. The process of obtaining competing bids has adequately dealt with the risk of self-dealing by management. Accordingly, the burden then shifts back to the plaintiff, whether shareholder or competing bidder, to show a breach of the directors' fiduciary

379. See *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,194, at 91,714-15 (Del. Ch. Jan 31, 1989), *appeal refused*, 556 A.2d 1070 (Del. 1989).

380. For a critique of fairness opinions in control transactions, see generally Bebchuk & Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27.

381. Cf. *Beebe v. Pacific Realty Trust*, 578 F. Supp. 1128, 1144-46 (D. Or. 1984) (federal proxy rules not violated where all conflicts of interest fully disclosed).

382. This parallels a proposal the SEC is currently considering in connection with MBO transactions. 21 Sec. Reg. & L. Rep. (BNA) 656 (May 5, 1989). *In re Wheelabrator Technologies, Inc. Shareholders Litig.*, [1990] Fed. Sec. L. Rep. (CCH) ¶ 95,489, at 97,560 (Del. Ch. Sept. 6, 1990), holds that shareholder approval of a challenged merger is a complete defense to a *Revlon*-based cause of action. In light of this Article's position on shareholder voting, the proposal does not adopt this view.

duties. If the plaintiff fails to rebut the business judgment rule, the court should enforce the lock-up, even if the shareholders have not yet approved the merger. On the other hand, if the plaintiff successfully rebuts the business judgment rule, the court should invalidate the lock-up provision, just as it would if the board had declined to conduct an auction in the first place or had failed to carry its initial burden of proof.

C. SUMMARY

The approach proposed by this Article has several advantages. By applying traditional business judgment rule standards to performance promises, cancellation fees, and lock-ups falling below the ten percent trigger level, it avoids the need for judicial review of the merits of the board's decision (something courts have long eschewed), as well as the need for subjective evaluation of the board's motives (something which is difficult in any context). Instead, judicial review can focus on the relatively objective duty of care standard: Did the target board jump through the proper hoops to reach an informed decision that is within the limits of its authority? On the other side of the ten percent threshold, the mandated control auction preserves the significant and essential check on management discretion provided by competing bidders. Moreover, the control auction approach allows the target board to grant lock-ups exceeding the ten percent threshold where appropriate. If the directors wish to do so, they need merely conduct a voluntary control auction subject to judicial review of their procedures. The auction process should adequately defuse the conflict of interest that would otherwise require invalidation of the lock-up.

V. CONCLUSION

All duty-based arguments ultimately are "circular: the law finds a duty not to act when an underlying analysis suggests the activity should be banned."³⁸³ Or, as Justice Frankfurter wrote in another context, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge those obligations?"³⁸⁴

383. Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. FLA. L. REV. 35, 56 (1986).

384. SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

Present law has largely failed to answer those questions with respect to exclusivity provisions and lock-ups.

Analysis must begin with a recognition that there is a potential conflict of interest in all negotiated acquisitions. Bidders may not offer side payments in every transaction, and if they do, the offer of side payments may not consciously affect management's decision. But the potential for a conflict of interest is simply too great for courts to ignore.

Unfortunately, the *Great Western*, *Jewel*, and *Van Gorkom* approaches essentially do just that. *Revlon* at least has the virtue of addressing the conflict of interest problem. The *Revlon* solution of a mandatory control auction in which both exclusivity provisions and lock-up options are viewed with deep suspicion, however, is not an appropriate solution for negotiated mergers. *Revlon* would severely restrict the board's ability to utilize not only lock-ups, but also performance promises and cancellation fees. Performance promises and cancellation fees, however, are essentially unobjectionable in the Single Bidder context. They simply do not affect the viability of competitive bidding as a constraint on management's conflict of interest because the second bidder is always free to bypass the exclusive merger agreement by making a tender offer directly to the target's shareholders. At the same time, performance promises and cancellation fees provide substantial benefits to the target and its shareholders. Accordingly, courts should routinely enforce them.

In contrast, effective lock-ups must be viewed with greater suspicion. The practical effect of an effective lock-up is to preclude meaningful competitive bidding and thereby eliminate the most potent constraint on management's conflict of interest. As a result, *Time* went too far in permitting managers to protect acquisitions from competition.

Preserving the viability of competitive bidding in negotiated acquisitions, however, does not require that management affirmatively auction the company among competing bidders in all cases. It merely requires that management not take any steps that are likely to preclude a rational potential acquirer from entering the bidding. The analytical framework proposed by this Article therefore permits a target board to bypass the auction process when granting exclusivity provisions that do not preclude competing bids and are likely to be socially desirable or at least unobjectionable. On the other hand, the proposal does not allow a board to grant bid-preclusive lock-up provi-

sions if the board does not first undertake a voluntary ex ante auction. This proposal thus optimally constrains the inherent risk of self-dealing by management.