DEFENSIVE STRATEGIES AND THE BUSINESS JUDGMENT RULE: DOES ALMOST ANYTHING GO IN DELAWARE?

I. INTRODUCTION

"The conduct of corporate affairs often produces highly charged, hostile battles for corporate control, battles which often resemble a corporate form of feudal warfare."[1] Nowhere is this statement more aptly illustrated than in the context of a hostile tender offer for control of a corporation. The virtually unprecedented increase in hostile takeover activity in recent years[2] has engendered a host of defensive responses[3] from target corporations who do not want to be acquired by a particular offeror or who have adopted a policy of remaining entirely independent.[4] One of the most recent defensive tactics is the target corporation's repurchase of its own stock.[5] This repurchasing scheme, however, has a novel twist: a stockholding raider is precluded from tendering its shares to the target.

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1. Warner Communications, Inc. v. Murdoch, 581 F. Supp. 1482, 1485 (D. Del. 1984).

2. *See* Block & Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L.J. 44, 44 n.1 (1983) [hereinafter cited as Block & Miller].

3. The corporate world has come a long way since the days when the proxy fight was the primary method of acquiring a corporation or defending against an acquisition. Common defensive strategies are discussed in E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 193-206 (1977); A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING (1981). *See also* Data Probe Acquisition Corp. v. Datatab, Inc., 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1326 (1984) (stock lock-up option); Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981) (target acquired corporation with which tender offeror was in competition, creating antitrust problems for the raider should the raider acquire the target); Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623 (D. Md. 1982) (counter-tender offer by target corporation for raider's stock).

4. *See* Block & Miller, *supra* note 2, at 44; *Panter*, 646 F.2d at 295-96 (discussing Field's longstanding policy of independence).

5. Selective stock repurchases are not a new phenomenon. Such repurchases have occurred in the form of "greenmail" since tender offers became the preferred method of attempting to gain control of a corporation. "Greenmail" refers to the practice of a target corporation repurchasing its own shares from a raider at a significant premium over the current market price. Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?*, 19 GA. L. REV. 281, 282 (1985) [hereinafter cited as Dennis].

Additionally, under Delaware law a corporation may repurchase its own stock

Part II of this note first discusses the standards by which corporate directors' actions are scrutinized in Delaware—the business judgment rule and its corollary, the primary purpose test. This section concludes that the selective tender offer recently approved by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*,[6] as well as other defensive maneuvers, is within the purview of both. Part III examines Unocal's selective repurchase and concludes that, while the tactic will have the desired effect of thwarting tender offers made by a stockholding raider, it will not discourage non-shareholder raiders, nor will it deter an offeror making an any-and-all bid[7] for a target corporation's stock.

II. STANDARDS BY WHICH CORPORATE DIRECTORS' ACTIONS ARE SCRUTINIZED

A. *The Business Judgment Rule and the Primary Purpose Test*

The Delaware General Corporation Law provides that directors, rather than shareholders, manage the business and affairs of the corporation.[8] Notwithstanding this seemingly broad grant of power, the courts have held that corporate directors owe a fiduciary duty to the corporation and its shareholders.[9] However, it has also been recognized that by the very nature of his position, a director has a certain amount of self-interest in decisions affecting the corporation.[10]

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from dissident shareholders. *See* Martin v. American Potash & Chem. Corp., 92 A.2d 295 (Del. 1952); DEL. CODE ANN. tit. 8, § 160(a) (1983).

6. 493 A.2d 946 (Del. 1985).

7. An any-and-all bid is an offer to buy all shares tendered to the offeror by a specified date. Reiser, *Corporate Takeovers: A Glossary of Terms and Tactics*, 89 CASE & COM. 35 (1984). *See* MacAndrews & Forbes Holdings, Inc. v. Revlon, 501 A.2d 1239 (Del. Ch. 1985).

8. DEL. CODE ANN. tit. 8, § 141(a) (1983), states in pertinent part: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."

9. *See* Singer v. Magnavox Co., 380 A.2d 969, 977 (Del. 1977) (quoting *Guth* with approval); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("While technically not trustees, they [corporate directors] stand in a fiduciary relation to the corporation and its stockholders.").

10. *See* Johnson v. Trueblood, 629 F.2d 287, 292 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981). Chief Judge Seitz, writing for the majority, stated:

> [I]t is . . . obvious that if directors were held to the same standard as ordinary fiduciaries the corporation could not conduct business. For example, an ordinary fiduciary may not have the slightest conflict of interest in any transaction he takes on behalf of the trust. . . . The very fact that

Consequently, directors' decisions have been reviewed under the business judgment rule or the primary purpose test.[11]

The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors.[12] According to the rule, directors are presumed to have "acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation."[13] A party challenging the directors' decision must rebut this presumption by showing fraud,[14] bad faith,[15] or gross negligence on the part of directors.[16] Absent such a showing, the courts will not substitute their judgment for the directors', especially where the majority of the board consists of outside, independent directors.[17]

The primary purpose test, first enunciated in *Bennett v. Propp*,[18] requires the court to determine whether the directors' decision was one primarily in the corporate interest or designed solely to maintain control.[19] To overcome the presumption afforded by the test, the plaintiff must show that the directors' *sole* motive was to perpetuate

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> the director wants to enhance corporate profits is in part attributable to his desire to keep shareholders satisfied so that they will not oust him.

Id.

11. *See infra* notes 21-23 and accompanying text.

12. DEL. CODE ANN. tit. 8, § 141(a) (1983). *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981).

13. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)). *See also* Warshaw v. Calhoun, 43 Del. Ch. 148, 154, 221 A.2d 487, 492-93 (1966) (citing Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A.2d 148 (1943)) ("The acts of directors are presumptively acts taken in good faith and inspired for the best interests of the corporation . . . ."); Arsht, *Fiduciary Responsibilities of Directors, Officers and Key Employees*, 4 DEL. J. CORP. L. 652, 660 (1979) [hereinafter cited as Arsht].

14. *See* Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971); Kors v. Carey, 158 A.2d 136, 140 (Del. Ch. 1960).

15. *See Warshaw*, 43 Del. Ch. at 157, 221 A.2d at 492-93.

16. *See* Penn Mart Realty Co. v. Becker, 298 A.2d 349, 351 (Del. Ch. 1972).

17. *Aronson*, 473 A.2d at 812. *See also Puma*, 283 A.2d at 696:

> [S]ince the transaction complained of was accomplished as a result of the exercise of independent business judgment of the outside, independent directors whose sole interest was the furtherance of the corporate enterprise, the court is precluded from substituting its uninformed opinion for that of the experienced, independent board members of Marriott.

18. 187 A.2d 405 (Del. 1962).

19. *Id.* at 411. The primary purpose test is probably better described as the foremost element to be considered in determining whether the business judgment rule will apply to the directors' decision. If it is found that the sole motive for the action taken was entrenchment, the presumption of sound business judgment evaporates.

themselves in office.[20] The burden then shifts to the directors to establish that the transaction had a valid business purpose. If the directors meet this burden, the presumption again applies and the board's action will be upheld.[21]

Regardless of which standard is used, the result will often be the same. Although the business judgment rule is inapplicable where there is a conflict of interest,[22] the primary purpose test will be satisfied "if the directors merely articulate a rational basis for their actions."[23] The directors are cloaked in a presumption that the transaction was made in the exercise of sound business judgment, and courts will not inquire into the substantive fairness of such actions unless the plaintiff makes a showing that the decision was not in the best interests of the corporation and its shareholders. Not surprisingly, this is often a difficult hurdle for plaintiffs to cross.[24]

Ideally, plaintiffs should not have to face such an uphill struggle. There are alternatives which, though more stringent than the business judgment rule or the primary purpose test, afford protection to directors acting in good faith while allowing plaintiffs more leeway

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20. *See Johnson*, 629 F.2d at 293.

21. *Id.* The dissent in *Johnson* interpreted *Bennett* to stand for the proposition that the burden of proof shifted to the directors once the plaintiff showed that retention of control was a motive. *Id.* at 300 (citing *Bennett*, 187 A.2d at 405). That this is clearly not the case is obvious from a reading of *Bennett* and its progeny. *See, e.g.*, Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964) ("[I]f the board has acted *solely or primarily* because of the desire to perpetuate themselves in office, the use of corporate funds for such purposes is improper.") (emphasis added); Petty v. Penntech Papers, Inc., 347 A.2d 140, 143 (Del. Ch. 1975) ("[T]he use of corporate funds to purchase corporate shares *primarily* to maintain management in control is improper.") (emphasis added).

22. *See* Arsht, *supra* note 13, at 660.

23. Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison-Pill" Preferred*, 97 HARV. L. REV. 1964, 1970 (1984) [hereinafter cited as Note, *Protecting Shareholders*]. *See also* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

24. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). In *Panter*, Marshall Field, faced with a particularly desirable tender offer (at least from the shareholders' point of view), took action to dissuade the offeror from acquiring Marshall Field. Specifically, Marshall Field purchased a group of stores which had been steadily losing money, and announced plans to open a new Marshall Field store in a Houston mall where its potential acquiror, Carter Hawley Hale, already had a store. *Id.* at 280-81. Notwithstanding Marshall Field's longstanding policy of independence, such actions clearly appeared designed to thwart any potential offers and to maintain current management. The Seventh Circuit, however, did not subscribe to this view and upheld the Marshall Field board's actions as a valid exercise of business judgment under Delaware law. *Id.* at 295-96.

to establish their claims. One approach would require directors to prove that their primary motive was not entrenchment after the plaintiff has made a *prima facie* showing that retention of control was *a* motive (the position espoused by Judge Rosenn in his *Johnson v. Trueblood* dissent).[25] A second suggested test would create a rebuttable presumption that the directors' action lacked a rational business purpose, thereby necessitating proof of a valid purpose sufficient to overcome this presumption.[26] Both approaches would place the burden of proof on the directors, who possess more information than the plaintiff about the motivation behind their decisions. Additionally, these approaches recognize that the events occurring subsequent to a hostile tender offer often unfold rapidly, leaving a plaintiff little time in which to garner information needed to meet the burden of the present standards.[27] Therefore, requiring the directors in the first instance to justify their actions as being in the best interests of the corporation seems to be a fairer allocation of the burdens while still affording protection to directors acting in good faith.

B. Selective Stock Repurchases Under Delaware Law

It is well established that a Delaware corporation may expend its funds to repurchase its own shares,[28] subject only to the requirement that the transaction be undertaken without fraud or unfairness.[29] It is equally well settled that a corporation may deal selectively with its stockholders, provided that the directors' primary purpose was not entrenchment.[30] These practices stem from the realization that corporate directors have a duty to oppose any action which, in their reasoned judgment, is detrimental to the corporation and its stockholders.[31] Consequently, directors' decisions to repurchase the shares

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25. *Johnson*, 629 F.2d at 300 (Rosenn, J., dissenting).

26. While this approach has not yet been accepted by the Delaware courts, the author suggests such an approach, simply as another less restrictive alternative to the business judgment rule.

27. *See infra* text accompanying notes 36-54.

28. DEL. CODE ANN. tit. 8, § 160(a) (1983) provides in part: "Every corporation may *purchase*, redeem, receive, take or otherwise acquire, own and hold, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with its own shares." (emphasis added.)

29. *See Martin*, 92 A.2d at 302; Kors v. Carey, 39 Del. Ch. 47, 55, 158 A.2d 136, 141 (1960).

30. *See Cheff*, 199 A.2d at 554; *Kors*, 39 Del. Ch. at 54, 158 A.2d at 141.

31. *See Panter*, 646 F.2d at 297; Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 704 (2d Cir. 1980); Northwest Indus., Inc. v. B.F. Goodrich Co., 301

of dissident stockholders have been sanctioned as a valid exercise of business judgment,[32] notwithstanding the fact that other shareholders are denied the opportunity to have their shares bought back at the same premium.[33] In cases where the repurchase was not vindicated, the courts found that the sole or primary motive for the action was the board's desire to retain control.[34] However, the Delaware courts had never before decided whether a selective stock repurchase authorized by a board in the face of a hostile offer which excluded from participation a shareholder making a tender offer for the target was valid.

1. The *Unocal* Decision

The Delaware Supreme Court was confronted with this issue of first impression in *Unocal Corp. v. Mesa Petroleum Co.*[35] The case arose out of a fiercely contested takeover bid for control of Unocal by Mesa, a Unocal shareholder, for control of Unocal. On April 8, 1985, Mesa, then owning approximately 13% of Unocal stock, announced a two-tiered front-end loaded[36] tender offer for 64 million

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F. Supp. 706, 712 (M.D. Ill. 1969); Kaplan v. Goldsamt, 380 A.2d 556, 569 (Del. Ch. 1977); *Cheff*, 199 A.2d at 556.

In *Cheff*, for example, the court held that the use of corporate funds to repurchase a dissident shareholder's stock was proper. *Id.* at 554. It found that the directors had a valid fear that the dissident, upon acquiring control of the company, planned to either liquidate it or institute a major change in its sales policies. The directors considered their special sales policies vital to the company's future success. The court determined that these stated intentions on the part of the dissident posed a reasonable threat to the company's continued existence or at least existence in its present form. *Id.* at 556. Since the directors' primary motivation was not entrenchment, the stock repurchase was a proper exercise of business judgment.

Similarly, in *Kaplan*, the court found that the board's repurchase of a dissident director's stock at a premium was valid in view of the director's repeated and vociferous disagreements with corporate policy and his "potential for disruption." *Kaplan*, 380 A.2d at 565.

32. *See* Heine v. Signal Cos., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,898 (S.D.N.Y. 1977) (applying Delaware law); *Cheff*, 199 A.2d at 554; *Kors*, 39 Del. Ch. at 54, 158 A.2d at 141.

33. The new wave of "greenmailers" have honed this practice to a fine art. Between 1979 and 1984, firms spent $5.5 billion in targeted share repurchase transactions, with an aggregate premium over market price of more than $1 billion. Dennis, *supra* note 5, at 282.

34. *See* Bennett v. Propp, 187 A.2d 405 (Del. 1962); Petty v. Penntech Papers, Inc., 347 A.2d 140 (Del. Ch. 1975); Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (1967).

35. 493 A.2d 946 (Del. 1985).

36. In a two-tiered front-end loaded bid, the offeror makes a cash tender offer for enough shares to acquire a majority interest in the corporation. The bidder,

shares[37] of Unocal stock at $54 per share.[38] However, Mesa subsequently disclosed that the securities to be exchanged in the second step merger would be highly subordinated "junk bonds."[39]

The Unocal board, consisting of eight independent outside directors and six inside directors, met on April 13 to consider the offer. Thirteen directors were present at the meeting,[40] which lasted

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upon gaining control, then merges the target into itself or an affiliate. Target shareholders who do not tender into the front end bid are eliminated in the second step mergers. The front end price is generally a significant premium over the shares' current market value. The second step price, however, is usually less than the front end price and often takes the form of debt or equity securities of the bidder rather than cash. Note, *Second Step Transactions in Two-Tiered Takeovers: The Case for State Regulation,* 19 GA. L. REV. 343, 344 (1985). The coercive nature of such offers has been well documented. *See* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers,* 88 HARV. L. REV. 297, 337 (1974); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation,* 83 COLUM. L. REV. 249, 306 (1983); Note, *Protecting Shareholders, supra* note 23, at 1966.

37. This was approximately 37% of Unocal's outstanding stock. Receipt of these shares would have given Mesa nearly 51% of Unocal stock. *Unocal,* 493 A.2d at 949.

38. *Id.*

39. *Id.* at 950. The supplement included in Mesa's proxy statement reads:

> (i) [F]ollowing the Offer, the Purchasers would seek to effect a merger of Unocal and Mesa Eastern or an affiliate of Mesa Eastern (the "Merger") in which the remaining Shares would be acquired for a combination of subordinated debt securities and preferred stock; (ii) the securities to be received by Unocal shareholders in the Merger would be subordinated to $2,400 million of debt securities of Mesa Eastern, indebtedness incurred to refinance up to $1,000 million of bank debt which was incurred by affiliates of Mesa Partners II to purchase Shares and to pay related expenses and all then-existing debt of Unocal; (iii) the corporation surviving the Merger would be responsible for the payment of all securities of Mesa Eastern (including any such securities issued pursuant to the Merger) and the indebtedness referred to in item (ii) above, and such securities and indebtedness would be repaid out of funds generated by the operations of Unocal; (iv) the indebtedness incurred in the Offer and the Merger would result in Unocal being much more highly leveraged, and the capitalization of the corporation surviving the Merger would differ significantly from that of Unocal at present; and (v) in their analyses of cash flows provided by operations of Unocal which would be available to service and repay securities and other obligations of the corporation surviving the Merger, the Purchasers assumed that the capital expenditures for exploration of such corporation would be significantly reduced.

Id. at 950 n.3. Consequently, the Unocal shareholders not tendering into the front end of the Mesa offer would receive securities subordinated to millions of dollars of Mesa indebtedness. These shareholders would, therefore, be receiving less in the long run than those whose shares were accepted in the front end.

40. *Id.* at 950. One outside director was in Japan on business. Defendants' Answering Brief in Opposition to Plaintiffs' Motion for a Preliminary Injunction at 15, Mesa Petroleum Co. v. Unocal Corp., No. 7997 (Del. Ch. May 13, 1985).

for nine and one-half hours. Although the directors were given no agenda or written materials prior to the meeting, detailed presentations were made by legal counsel as to the board's responsibilities under both Delaware law and federal securities law.[41] The board then received a presentation from a representative of Unocal's investment bankers, who opined that Mesa's offer was inadequate.[42] He also presented various defensive strategies available to Unocal in the event the board decided to oppose Mesa's offer, including a self-tender by Unocal for its own stock. Though such an action would cause Unocal to incur between $6.1 and $6.5 billion of additional debt, the board was informed that Unocal would be able to service the debt and still remain a viable entity.[43]

The eight outside directors then met separately with Unocal's financial advisors and attorneys. These directors agreed to advise the board to reject Mesa's tender offer as inadequate and to pursue a self-tender offer to provide Unocal's shareholders with a fair alternative to the Mesa proposal.[44] The board did adopt a resolution condemning the Mesa offer as grossly inadequate, but it failed to reach a decision as to the self-tender offer.[45]

The board met again on April 15 to discuss the self-tender offer.[46] Unocal's vice-president of finance and its assistant general counsel presented the proposed terms of the offer. The board considered a price range between $70 and $80 per share and ultimately adopted a price of $72.[47] Additionally, the board was informed of the debt securities to be issued and the necessity of restrictive covenants to govern certain corporate activities until the obligations were extinguished. Based upon the advice of the investment bankers and its own deliberations, the directors unanimously approved the ex-

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41. *Unocal*, 493 A.2d at 950.

42. *Id.* The representative informed the directors that the minimum cash value which Unocal could expect to receive from a sale or orderly liquidation of 100% of its stock exceeded $60 per share. He supplemented his presentation with slides outlining the valuation techniques used by the financial advisors and depicting recent business combinations in the oil and gas industry. *Id.*

43. *Id.*; Defendants' Answering Brief in Opposition to Plaintiffs' Motion for a Preliminary Injunction at 17, Mesa Petroleum Co. v. Unocal Corp., No. 7997 (Del. Ch. May 13, 1985).

44. *Unocal*, 493 A.2d at 950.

45. *Id.*

46. One director was absent. Four others were present by conference telephone, which is permissible under DEL. CODE ANN. tit. 8, § 141(i) (1983). *Unocal*, 493 A.2d at 950-51.

47. *Unocal*, 493 A.2d at 951.

change offer.[48] The resolution provided that if Mesa acquired the 64 million shares sought in its offer, Unocal would purchase the remaining 49% for an exchange of debt securities worth $72 per share.[49] However, the self-tender offer excluded Mesa since allowing Mesa to participate would defeat the "purport and intent" of the offer.[50]

Unocal announced its exchange offer on April 17. Mesa immediately challenged it by filing suit in the Delaware Court of Chancery.[51] On April 22, the Unocal board met again with its investment bankers, who advised the board to waive the Mesa purchase condition with respect to 50 million shares.[52] The bankers also recommended that the directors tender their own stock into the exchange offer to prove their confidence in the offer.[53] Also on April 22, Mesa amended its complaint to allege its exclusion from the exchange offer.[54]

On April 22, the chancery court temporarily restrained Unocal from proceeding with its tender offer unless Mesa was permitted to participate to the same extent and in the same manner as all other Unocal shareholders.[55] On May 2, the supreme court deferred Unocal's application for certification of an interlocutory appeal until the chancery court had ruled on Mesa's request for a preliminary injunction.[56] However, the supreme court did pose a series of questions

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48. *Id.*

49. *Id.*

50. *Id.* The board felt that the Mesa exclusion was necessary for two reasons. First, Mesa's participation would encourage the Mesa offer, since Mesa would be able to sell shares for $72 and repurchase them at $54, thereby placing Unocal in the position of financing the very tender offer it was trying to defeat. Second, each Mesa share purchased by Unocal would displace one share tendered by a Unocal public stockholder, thus reducing the value available to these stockholders, whom the Unocal offer was intended to benefit. *Id.* at 951.

51. Mesa Petroleum Co. v. Unocal Corp., No. 7997 (Del. Ch. May 13, 1985).

52. *Unocal*, 493 A.2d at 951. This recommendation was made in response to shareholder concerns that if shares were tendered to Unocal, neither Unocal nor Mesa would accept them. *Id.*

53. *Id.* The amount to be received by the directors under the exchange offer was hotly debated. *See* Plaintiffs' Opening Brief in Support of their Motion for a Preliminary Injunction at 38-41, Mesa Petroleum Co. v. Unocal Corp., No. 7997 (Del. Ch. May 13, 1985); Defendants' Answering Brief in Opposition to Plaintiffs' Motion for a Preliminary Injunction at 23-24, Mesa Petroleum Co. v. Unocal Corp., No. 7997 (Del. Ch. May 13, 1985).

54. *Unocal*, 493 A.2d at 951.

55. Mesa Petroleum Co. v. Unocal Corp., No. 7997, slip op. at 24 (Del. Ch. Apr. 22, 1985); Greene, Lewkow & Dupler, Unocal *May Have Limited Impact as Precedent*, L.A. Daily J., June 11, 1985, at 3, col. 4.

56. *Unocal*, 493 A.2d at 952.

for the chancery court to consider.[57] The chancery court issued a preliminary injunction on May 13,[58] stating that "[t]he purpose of the exchange offer is to defeat Mesa's takeover bid and the record evidence supports a conclusion that the substantial debt to be incurred as a result of the exchange offer together with the restrictive covenants . . . will make it more difficult for Mesa to succeed in its takeover efforts."[59] The vice-chancellor certified the interlocutory appeal to the supreme court as a matter of first impression,[60] and that court accepted the appeal on an expedited basis on May 14.[61]

The supreme court held, contrary to the chancery court, that Unocal's directors exercised sound business judgment in authorizing the self-tender offer which excluded Mesa.[62] The court began by noting that "in the broad context of corporate governance, including

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57. *Id.* The questions were as follows:

a) Does the directors' duty of care to the corporation extend to protecting the corporate enterprise in good faith from perceived depredations of others, including persons who may own stock in the company?

b) Have one or more of the plaintiffs, their affiliates, or persons acting in concert with them, either in dealing with Unocal or others, demonstrated a pattern of conduct sufficient to justify a reasonable inference that a principle [sic] objective of the plaintiffs is to achieve selective treatment for themselves by the repurchase of their Unocal shares at a substantial premium?

c) If so, may the directors of Unocal, in the proper exercise of business judgment, employ the exchange offer to protect the corporation and its shareholders from such tactics?

d) If it is determined that the purpose of the exchange offer was not illegal as a matter of law, have the directors of Unocal carried their burden of showing that they acted in good faith?

Id. (citations omitted). These questions were a clear-cut indication that the supreme court viewed this case as one to which the business judgment rule would apply in the absence of a primary purpose of entrenchment, fraud, or bad faith.

58. *Unocal*, No. 7997, slip op. at 24.

59. *Id.* In response to the supreme court's questions, *supra* note 57, the chancery court found: first, that the directors' duty of care extends to the protection of the corporation from perceived harm, regardless of its source; second, that Pickens' (president and chairman of the board of Mesa Petroleum Co.) notoriety as a "greenmailer" was well documented, thus justifying a reasonable inference that Mesa's objective was to be bought off at a substantial premium; and, in response to the third and fourth questions, that although the Unocal directors' decision to oppose Mesa's offer was made in good faith, the business judgment rule did not apply to a selective exchange offer which excludes some shareholders but not others. *Id.* at 12-19.

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

61. *Id.* Expedition was necessary because if Unocal were permitted to proceed with its tender offer, the proration period ended on May 17. Mesa's tender offer expired on May 23. *Id.* at 953 n.5.

62. *Id.* at 958.

issues of fundamental corporate change, a board of directors is not a passive instrumentality."[63] The court went on to conclude that a board of directors has the power to deal selectively with its stockholders in order to protect the corporation from harm it reasonably perceives, irrespective of the source,[64] as long as the directors' sole or primary motive is not to retain control.[65] Deciding that the business judgment rule is applicable in the context of a takeover attempt,[66] the court turned its attention to the selective stock repurchase utilized by Unocal.

The court first observed that for the business judgment rule to apply to a defensive measure adopted in the face of a hostile takeover attempt, the measure must be reasonable in relation to the threat posed.[67] The directors must, therefore, consider the nature of the takeover bid and its potential effect on the corporate enterprise.[68] Specifically, the court stated, "[I]t also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor."[69] The court then considered the particular concerns articulated by Unocal in its adoption of the selective tender offer and found these concerns to be valid.[70]

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63. *Id.* at 954.

64. *Id.* at 953-54. This authority stems from two sources: the Delaware General Corporation statute (specifically DEL. CODE ANN. tit. 8, §§ 141(a), 160(a) (1983), and case law interpreting these provisions), and the board's fiduciary duties and obligations to the corporation (which includes the shareholders). *Id. See also supra* notes 8, 28-34 and accompanying text.

65. *Unocal*, 493 A.2d at 954. *See supra* notes 18-21 and accompanying text.

66. When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment.

Unocal, 493 A.2d at 954.

67. *Id.* at 955.

68. *Id.* The court listed examples of concerns which the board may take into account in its analysis of the tender offer, including the adequacy of the offered price, the nature and timing of the offer, questions of illegality, the impact on constituencies other than shareholders, the risk of nonconsummation, and the quality of the securities being offered in the exchange. *Id.*

69. *Id.* at 955-56.

70. *Id.* at 956. The court found that the directors had concluded that Unocal's value was substantially higher than the $54 per share offered in the front end; the securities to be exchanged in the back-end merger were highly subordinated "junk bonds"; the offer was made by a raider with a national reputation as a "green-

Finally, the court addressed Mesa's contention that discrimination against a shareholder was unlawful. Reiterating its holding that selective stock repurchases are permissible under Delaware law, the court noted that, prior to Unocal, courts had approved payment of "greenmail' to a dissident or raider shareholder.[71] Emphasizing that other shareholders were denied the same favorable treatment in these cases, the court pointedly remarked that "given Mesa's past history of greenmail, its claims here are rather ironic."[72] Accordingly, the court dismissed as meritless Mesa's claim of disparate treatment.[73]

C. *The Business Judgment Rule and Other Defensive Maneuvers*

The Unocal court's decision to apply the business judgment rule to a defensive strategy is not without precedent in Delaware law. The chancery court, as well as other courts applying Delaware law, have had occasion to determine the validity of several defensive measures under the rule and have generally held that adoption of such tactics is within the board's prescribed authority.[74]

In *GM Sub Corp. v. Liggett Group, Inc.*,[75] the chancery court denied GM's request for an order temporarily restraining Liggett, for whom GM had made a tender offer, from selling its subsidiary Austin Nichols to a third party. GM alleged that the sale was made for entrenchment purposes.[76] The court acknowledged that the motivating factor behind Liggett's desire to sell Austin Nichols was GM's attempt to gain control of Liggett and that it was realistic to assume that Liggett contemplated that the effect of the sale would be to cause GM to lose interest in its tender offer.[77] Nevertheless, the court found that Liggett's expressed fear, that once GM acquired control of Liggett it would then purchase Austin Nichols for far less

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mailer"; and that to allow Mesa to participate in the tender offer would frustrate the intent of the offer. *Id.*

71. *Id.* at 957 (citing *Cheff*, 199 A.2d at 554; *Bennett*, 187 A.2d at 408; *Martin*, 92 A.2d at 302; *Kaplan*, 380 A.2d at 568-69; *Kors*, 158 A.2d at 140-41). The court noted that these cases were distinguishable from *Unocal* only insofar as they concerned payments to the raider to the exclusion of all other stockholders. *Id.*

72. *Unocal*, 493 A.2d at 957. For a description of Mesa's past history of greenmail, see *Unocal*, No. 7997, slip op. at 14-15.

73. *Unocal*, 493 A.2d at 959.

74. *See infra* notes 108-123 and accompanying text.

75. No. 6155 (Del. Ch. Apr. 24, 1980), *rev'd on other grounds*, 415 A.2d 473 (Del. 1980).

76. *Id.* at 2.

77. *Id.* at 3.

than its worth, justified application of the business judgment rule to the Liggett directors' actions.[78]

In *National Education Corp. v. Bell & Howell Co.*,[79] the chancery court considered whether Bell & Howell's proposed issuance of "piggyback" preferred stock, adopted in the absence of a takeover attempt, should be enjoined.[80] The plaintiff, characterizing the issuance of the new preferred stock as an anti-takeover scheme, asserted that this was "an improper attempt by the members of the defendant's incumbent management to tamper with the corporate voting machinery so as to entrench themselves."[81] In denying the plaintiff's request for a preliminary injunction, the court found that the new preferred stock included rights other than those related to voting power and would have independent trading value.[82] Therefore, its issuance was not an attempt by current management to maintain control.[83] Additionally, the court specifically observed that nine of the defendant's eleven directors were independent outsiders.[84]

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78. *Id.* at 3-4. The court stated that:

> not every action taken by a board of directors to thwart a tender offer is to be condemned. The test . . . is whether the board is fairly and reasonably exercising its business judgment to protect the corporation and its shareholders against injury likely to befall the corporation should the tender offer prove successful.

Id. at 3 (citations omitted).

79. No. 7278 (Del. Ch. Aug. 25, 1983), *printed in* 8 DEL. J. CORP. L. 610 (1983).

80. *Id.* at 1-2. The new preferred stock was to be distributed to all Bell & Howell common shareholders as a stock dividend on the basis of one share of the new preferred for every 20 shares of common. Fractional shares of the preferred would be issued in order to distribute the preferred in direct proportion to ownership of the common (for example, if a shareholder owned 10 shares of common stock, he would receive a one-half share of the new preferred). *Id.* at 1. The new preferred gave its holders an 80% supermajority voting power in the event of certain mergers or business combinations and also entitled its holders to special conversion and redemption rights should 40% or more of Bell & Howell's outstanding common stock be acquired by another party. *Id.* at 1-2.

81. *Id.* at 2.

82. *Id.* at 10.

83. *Id.* The court noted that the result of this issuance might be the retention of control by current management. *Id.* Clearly, the requirement of an 80% supermajority approval on mergers and combinations would make it difficult for a prospective raider to oust incumbent management or even to mount a hostile takeover campaign in the first instance. Regardless, since perpetuation of control was not the directors' primary purpose in adopting this scheme, the business judgment rule would sustain their actions. *Id.*

84. *Id.* at 3.

The chancery court confronted a voting rights lock-up provision in *Thompson v. Enstar Corp.*[85] and concluded that the actions taken by Enstar's incumbent board in the midst of a hotly contested proxy fight were within the ambit of the business judgment rule.[86] The court found that the board had reasonably determined that the tender offer at issue was the only bona fide offer which it had received and that the transaction would fail if the lock-up provision[87] was not included.[88] As a result, the court denied the plaintiff's application for a preliminary injunction on the grounds that the plaintiff had failed to show that the directors' action in acceding to the offeror's demand was unreasonable.[89] Again, the court pointed out that ten of Enstar's twelve directors were outsiders having no interest in the outcome of the sale or the litigation.[90]

In *Moran v. Household International, Inc.*,[91] the chancery court, affirmed by the Delaware Supreme Court, upheld Household's issuance of "poison-pill" preferred stock.[92] The plaintiff, a director of

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85. Nos. 7641 & 7643 (Del. Ch. June 20, 1984), *revised* July 5, 1984 & Aug. 16, 1984, *printed in* 9 DEL. J. CORP. L. 822 (1984).

A lock-up occurs when a target corporation grants a favored suitor a competitive advantage over other bidders. In a stock lock-up, the preferred bidder either receives an option to purchase or purchases authorized but unissued shares of the target. *See* Data Probe Acquisition Corp. v. Datatab, Inc., 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1326 (1984). In an asset lock-up, the target gives the favored party an option to purchase, or the party does purchase, a valuable asset of the target. *See* Mobil Corp. v. Marathon Oil Corp., 669 F.2d 366 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982).

86. *Enstar*, Nos. 7641 & 7643, slip op. at 12-13.

87. Enstar had granted voting control over Enstar Indonesia, its most valuable asset, to Unimar as a condition of Unimar's tender offer. *Id.* at 11. While Enstar remained free to receive and accept other tender offers, the lock-up provision was irrevocable. Consequently, Unimar would retain voting control of Enstar Indonesia without regard to whomever ultimately gained control of Enstar. *Id.* at 11-12.

88. *Id.* at 13.

89. *Id.*

90. *Id.* at 5.

91. 490 A.2d 1059 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985).

92. *Id.* at 1083. Household called its preferred stock plan the "Rights Plan." *Id.* at 1063. Under the plan, each shareholder received one right for each share of common stock outstanding. The right lasted for ten years and allowed the holder to buy one hundredth of a share of a new series of participating preferred stock. *Id.* at 1066. The new preferred was nonredeemable and subordinate to other series of preferred stock. Its dividend right was tied to the dividend for common at 100 times the dividend declared on common stock. *Id.* The exercise price for the preferred was $10,000 per share. The current dividend yield for common was only $1.75 and it was trading at the time between $30-$33. The rights could only be exercised if certain 20% and 30% triggering events occurred. *Id.* Prior to occurrence, the rights were nontransferable. A holder could only exercise his right if he acquired

Household and chairman of the board of the corporation owning the largest amount of Household stock,[93] challenged the adoption of the plan on the grounds that it would entrench management and deny shareholders the opportunity to sell their shares at a premium in a tender offer.[94] While conceding that all the directors were aware that implementation of the plan would make a hostile two-tier takeover more unlikely, Household asserted that its action in approving the plan was protected by the business judgment rule.[95] The court agreed that the presumption of sound business judgment applied to directors choosing pre-planned strategies "as well as devices adopted on an *ad hoc* basis,"[96] especially where, as in this case, outside directors comprised a majority of the board.[97] Thus, the burden remained on the plaintiff to show that the directors' decision was motivated primarily by a desire to retain control.[98] Based on the evidence presented, the court found that the Household board's action was an appropriate exercise of managerial judgment under the business judgment rule.[99]

The chancery court has also applied the rule to resistance efforts undertaken by the directors of Phillips Petroleum in fending off an unsolicited hostile tender offer by Mesa Petroleum in *Edelman v. Phillips Petroleum Co.*[100] Upon learning of Mesa's tender offer, Phillips engaged Mesa in a battle of lawsuits[101] designed in part to discourage

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20% of Household's common stock (or the right to vote 20% of the shares) or put together a group holding 20%, at which time they could act together. The 30% event occurred if a tender offer was announced for 30% of Household's outstanding stock. *Id.*

Once a triggering event occurred, the rights could be exchanged for new preferred upon payment of the exercise price. Additionally, if a merger or consolidation occurred where Household's common shares would be exchanged for securities of the acquiror, the right "flipped-over" and allowed the holder, at the then exercise price of the right, to buy common stock of the acquiror at a price reflecting a market value of twice the exercise price of the right. The right holder could, therefore, buy $200 worth of the acquiror's common for $100, thus diluting the acquiror's capital. *Id.*

93. *Id.* at 1063.

94. *Id.* at 1067.

95. *Id.* at 1068.

96. *Id.* at 1076.

97. *Id.* at 1074-75. Of the 16 Household directors, 9 were independent outsiders. *Id.* at 1064.

98. *Id.* at 1076.

99. *Id.* at 1083.

100. Edelman v. Phillips Petroleum Co., No. 7899 (Del. Ch. Feb. 12, 1985).

101. These suits include, in order of filing: (1) an action brought by Mesa in the United States District Court for the District of Delaware on December 4, 1984, to enjoin the enforcement of the Delaware Tender Offer Act (DEL. CODE ANN. tit.

or delay Mesa's advances.[102] The plaintiff, a Phillips shareholder, argued that Phillips' litigation was a waste of corporate assets and was designed to entrench current management.[103] The court, however, opined that the conduct of Phillips' management during the time in which it resisted Mesa's takeover attempt was "clearly the most defensible aspect of its reaction."[104] The court held that, on the record before it, Phillips' initial efforts to thwart Mesa's interest did not appear calculated to enable the board to maintain control.[105] Furthermore, given the rapid pace at which the events unfolded subsequent to Mesa's tender offer announcement, Phillips' response did not lack a rational basis.[106] Consequently, the plaintiff's application for a preliminary injunction was denied.[107]

Federal courts applying Delaware law have also upheld defensive tactics as a valid exercise of business judgment. In *Heine v. The Signal*

8, § 203 (1983); (2) the present action, commenced by Mesa on December 5, 1985; (3) the *ex parte* securing of a temporary restraining order in Oklahoma by Phillips to prevent Mesa from moving against Phillips; (4) Mesa's further resort to Delaware Court of Chancery to restrain Phillips from initiating further proceedings in any other federal court; and (5) a Louisiana state court action to prevent Mesa from attempting to acquire an interest in certain of Mesa's assets in Louisiana without prior state regulatory agency approval. Mesa Partners v. Phillips Petroleum, No. 7871, slip op. at 2 (Del. Ch. Dec. 20, 1984).

102. *Edelman*, No. 7899, slip op. at 8. Phillips also devised an exchange offer plan which would permanently alter the company's capital structure by shifting majority stock ownership to Phillips' employees. Furthermore, Phillips announced a recapitalization plan as a general takeover response which would significantly reduce the number of publicly held shares but would not render Phillips acquisition-proof. Plaintiff challenged this capitalization plan as well. *Id.* at 1, 8.

103. *Id.* at 9. Rather than litigating Mesa's right to make a tender offer and retaining investment bankers, plaintiff contended that Phillips' response should have been to ask Mesa if it would guarantee the same price in the second step of its tender offer as it was offering in the front end. *Id.*

104. *Id.* at 11.

105. *Id.* at 13.

106. *Id.* The court stated:

> Mesa's acquisition intentions, gleaned from its Section 13D . . . reflected a classic two-tiered tender offer with no commitment to the terms of the second tier. . . . Mesa's refusal to commit itself to the terms of the second step clearly justified the belief by Phillips' management and directors that Mesa, whose principal, T. Boone Pickens, possessed impressive credentials as a corporate acquiror, did not have the best interests of Phillips and all its shareholders in mind. If the litigation efforts of Phillips in the next two weeks may be viewed as simply buying time, it cannot be said that such conduct was not a proper exercise of managerial judgment as part of an overall effort to resist a potentially destructive tender offer.

Id. at 11-12.

107. *Id.* at 27.

Companies, Inc.,[108] the District Court for the Southern District of New York sustained Signal's disparate treatment of stockholders in paying "greenmail" to a group of dissident shareholders.[109] The court, citing *Cheff v. Mathes*,[110] stated that "Delaware law, with reasonable liberality, permits the use of corporate funds by directors to buy out dissident shareholders when such a tack is based on a 'sincere belief that the buying out of the dissident stockholder[s] [is] necessary to maintain . . . proper business practices.' "[111] The court also recognized that the use of corporate funds to repurchase the shares would be improper if the sole or primary purpose was to maintain control.[112] Given the fundamental policy differences between Signal's management and the dissidents, as well as the "antagonistic skirmishes" which occurred between the two groups,[113] the district judge found that the transaction was in the best interests of the corporation.[114]

In *Panter v. Marshall Field & Co.*,[115] cited with approval by the *Unocal* court, [116] the Seventh Circuit upheld the Marshall-Field board's decision to acquire a group of stores in the face of a hostile takeover attempt by Carter Hawley Hale (CHH). Emphasizing Marshall-Field's express policy of remaining independent[117] and the majority of outside, disinterested directors on the board,[118] the court held that the directors were entitled to protection under the Delaware business judgment rule.[119] The court found the plaintiff's allegation that Marshall-Field's defensive acquisitions were designed to lessen its at-

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108. [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,898 (S.D.N.Y. 1977).

109. *Id.* at 91,323.

110. 199 A.2d 548 (Del. 1962).

111. *Heine*, [1976-1977 Transfer Binder] FED. SEC. L. REP. at 91,322.

112. *Id.*

113. *Id.* at 91,323.

114. *Id.* The district judge found no evidence to support plaintiff's claim that Signal's directors felt threatened by the dissidents, nor for the contention that the transaction was authorized solely for the purpose of extinguishing the spectre of personal liability in an action pending in Delaware. Moreover, the record presented purely financial reasons for the repurchase which the court found were probably sufficient in and of themselves to support the directors' actions. *Id.*

115. 646 F.2d 271 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981). Plaintiff also alleged a number of violations of the federal securities laws.

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

117. *Panter*, 646 F.2d at 296.

118. Seven of the ten directors on the Field board were outsiders. *Id.* at 278.

119. *Id.*

tractiveness as a candidate for acquisition and to exacerbate any antitrust problems which CHH might face from a merger to be utterly devoid of merit.[120] Even assuming that one of Marshall-Field's motives was to discourage the CHH offer, plaintiffs failed to establish that this was the directors' sole or primary motive as required by *Bennett* and *Cheff*.[121] Concluding that the Marshall-Field directors' defensive actions did not violate Delaware law, the Seventh Circuit affirmed the judgment of the district court.[122]

If these and other cases sanctioning defensive measures under the business judgment rule[123] are taken at face value, it appears that the rule grants directors almost carte blanche authority to engage in all but the most patently illegal defensive maneuvers, secure in the knowledge that their decision will be protected.[124] For this reason, several commentators have asserted that different standards should be applied to judge the validity of defensive tactics adopted in the heat of a takeover battle.[125]

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120. *Id.* at 297. "[P]laintiffs have brought forth no evidence of bad faith, overreaching, self-dealing or any other fraud necessary to shift the burden of justifying the transaction to the defendants. It is precisely this sort of Monday-morning quarterbacking that the business judgment rule was intended to prevent." *Id.* at 297.

121. *Id.*

122. *Id.*

123. *See, e.g.*, Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690 (2d Cir. 1980) (merger of target corporation and third party with whom the target had been negotiating prior to the hostile tender offer); Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980) (issuance of a block of stock to prospective "white knight" merger partner); Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969) (target's purchase of the remaining half of its half-owned subsidiary).

124. It has been alleged that "Delaware law is tantamount to a license to mismanage or deal unfairly with stockholders, and that Delaware courts will not enforce even minimal standards." Arsht, *supra* note 13, at 652.

125. *See, e.g.*, Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (arguing that management and directors should be severely limited in their ability to take defensive action when confronted with a tender offer) [hereinafter cited as Easterbrook & Fischel]; Gelfond & Sebastian, *Reevaluating the Duties of Target Management in a Hostile Tender Offer*, 60 B.U.L. REV. 403 (1980) (suggesting that the business judgment rule is applicable when the directors are truly independent but advocating a stringent liability standard of judicial review when the decisions are made by interested management); Cary, *A Proposed Federal Corporation Minimum Standards Act*, 29 BUS. LAW. 1101 (1974) (advocating a general federal corporation standard).

However, there are commentators who prefer the rule as it currently stands. *See, e.g.*, Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979) (contending that directors should be permitted to undertake defensive actions and that their doing so actually benefits the shareholders).

However, the business judgment rule is not quite as generous as it first appears. While it does vest a presumption of sound business judgment in a board of directors, that presumption is rebutted when the plaintiff makes a showing that the board's sole or primary motive was perpetuation of control.[126] Additionally, the directors' decision must also be an informed one; there is no protection for "an unintelligent or unadvised judgment."[127] Recognizing that directors are necessarily confronted with conflicts of interest, thereby making objective decisions difficult,[128] courts place the burden upon directors to justify their action as primarily in the corporation's and the shareholders' interests only after the plaintiff has made the required showing.[129]

The business judgment rule is not a vehicle for upholding directors' actions at any cost. This is illustrated by the Delaware Chancery Court's most recent decision in *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*,[130] which was affirmed by the Delaware Supreme Court.[131] Pantry Pride had proposed a friendly acquisition of Revlon at a price between $40 and $50 per share, a price Revlon considered to be far below its value. Further attempts to continue the discussion were rebuffed by Revlon.[132] Undaunted, Pantry Pride persisted in its efforts to acquire Revlon.[133] The Revlon directors responded by adopting a two-part plan composed of an exchange

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126. Although this showing may be difficult, it is not impossible. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (board's decision to approve cash-out merger was not the product of informed business judgment); Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971) (management attempted to obstruct dissident stockholders' exercise of right to undertake a proxy contest in order to cement entrenchment); Bennett v. Propp, 187 A.2d 405 (Del. 1962) (president's use of corporate funds to repurchase company's stock was done for sole purpose of maintaining control); Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (1967) (corporation's issuance of authorized but unissued shares to third party for sole purpose of perpetuating control).

127. *Van Gorkom*, 488 A.2d at 872.

128. *See Bennett*, 187 A.2d at 409.

129. *See id.*

130. 501 A.2d 1239 (Del. Ch. 1985) [hereinafter referred to as *Pantry Pride*].

131. The Delaware Supreme Court heard the case on an expedited appeal. A bench opinion was issued orally on November 1, 1985.

132. *Pantry Pride*, 501 A.2d at 1243.

133. *Id.* Pantry Pride authorized its chief executive officer to offer to acquire Revlon in a negotiated acquisition at $42 or $43 per share. *Id.* Revlon told Pantry Pride that its price was "ridiculous" and that Revlon would be willing to discuss an acquisition only if Pantry Pride would sign a standstill agreement which would require the Revlon board's approval of an acquisition. Pantry Pride refused to sign a standstill agreement. *Id.* at 1243-44.

offer to repurchase Revlon stock and a poison pill. The plan was designed to maximize and protect the value of Revlon's shares when faced with a tender offer.[134] Pantry Pride then launched a hostile any-and-all bid for Revlon shares at $47.50 per share. The Revlon board rejected this offer as grossly inadequate and implemented its own exchange offer.[135] Pantry Pride commenced another tender offer contingent upon its receipt of at least 90% of the Revlon shares.[136] However, unknown to Pantry Pride, Revlon had been negotiating with Forstmann Little and Adler & Shaykin to arrange a leveraged buy-out of Revlon.[137] The directors again rejected Pantry Pride's offer and authorized management to negotiate with other prospective buyers.[138] Pantry Pride offered $50 per share for a merger agreement with Revlon and subsequently increased the offer to $53 per share.[139] The Revlon board proceeded to unanimously approve a leveraged buy-out by Forstmann Little at $56 per share.[140] Pantry Pride then made an offer of $56.25.[141] Forstmann Little countered with an offer of $57.25, subject to several conditions.[142] It demanded a lock-up option to purchase two of Revlon's divisions, which could be exercised whenever any person or group acquired 40% of Revlon's shares.[143] More important, the offer forbade Revlon from soliciting any other offers.[144] The Revlon directors unanimously voted to accept the Forstmann Little offer.[145]

Pantry Pride raised its offer to $58 per share and also filed suit in chancery court, seeking to enjoin the proposed transaction.[146] The Revlon directors asserted that they were protected by the business judgment rule. The court agreed that the business judgment rule was applicable in this situation but indicated, citing *Unocal*, that the

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134. *Id.* Revlon's investment banker told the directors that he believed Pantry Pride would finance its tender offer with "junk bonds" and then effect a partition of Revlon's divisions in order to pay the financing. *Id.* at 1243.

135. *Id.* at 1244.

136. *Id.* at 1244-45.

137. *Id.* at 1245.

138. *Id.*

139. *Id.*

140. *Id.* This agreement also gave Revlon's management the opportunity to acquire an equity interest in the corporation. *Id.*

141. *Id.*

142. *Id.* at 1245.

143. *Id.*

144. *Id.* at 1245-46.

145. *Id.* at 1246.

146. *Id.* In addition to requesting an injunction, Pantry Pride sought to invalidate the original two-part plan adopted by Revlon on August 19.

particular defensive response must be reasonable in relation to the threat perceived.[147] The court found that the poison pill and exchange offer were justified by the directors' desire to preserve Revlon in its corporate form.[148]

However, the court viewed the events subsequent to Pantry Pride's $53 per share offer differently. Thereafter, the Revlon board proceeded as if a breakup of the company was a virtual certainty.[149] The board was no longer fending off a hostile offeror who would dismantle the corporation. On the contrary, it was "an auctioneer attempting to secure the highest price for the pieces of the Revlon enterprise."[150] The board, once committed to the breakup, did not invite equal participation in negotiations; Pantry Pride was excluded.[151] The court found that in accepting the Forstmann Little offer of $57.25, which included the lock-up and no-shop clauses, the board violated its fiduciary duty to the shareholders.[152] While noting that lock-ups are not per se illegal, the court stated that such a provision must advance or stimulate the bidding process.[153] Consequently, the business judgment rule did not protect a board's action

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147. *Id.* at 1247.

148. *Id.* at 1247-50. Such a reason was held valid in *Cheff*. *See supra* note 31. However, the court did not appear to be altogether convinced that the independent director feature of the poison pill was present. It noted that of Revlon's 14 directors, 6 were employed in management capacities, 2 owned substantial amounts of Revlon stock, and a number of the remaining directors were presently or had previously been affiliated with companies doing business with Revlon. *Pantry Pride*, 501 A.2d at 1243 n.2. Moreover, the court expressed its belief that, in adopting the poison pill, the board provided a substitute for the marketplace which ordinarily judged the merits of a potential acquiror's tender offer. This was particularly significant since all of Pantry Pride's offers subsequent to the board's decision were cash any-and-all bids, in which all shareholders would be treated equally. *Id.* at 1247. Thus, contrary to the situation in *Unocal*, there was no fear that any shareholders would be relegated to the back end of a coercive two-tiered tender offer. Nevertheless, under *Moran* and *Unocal*, the poison pill and exchange offer were covered by the business judgment rule.

149. *Pantry Pride*, 501 A.2d at 1248.

150. *Id.*

151. *Id.* The board preferred Forstmann Little because Forstmann was committed to upholding the value of notes issued to shareholders who tendered their shares to Revlon in the exchange offer portion of the two-part plan adopted on August 19. The notes had been declining in value since the announcement of the October 3 agreement with Forstmann and the noteholders were threatening litigation. *Id.* at 1248-49. Pantry Pride would not agree to guarantee the value of the notes. Moreover, Forstmann's financing was allegedly firmly in place, while Pantry Pride's was not. *Id.* at 1249.

152. *Id.* at 1250.

153. *Id.* The court distinguished Thompson v. Enstar Corp. (*see supra* notes

in extending a lock-up where it "foreclose[d] further bidding in an active bidding situation and . . . promote[d] an agreement which relieve[d] the directors of the potentially damaging consequences of their own defensive policies."[154]

While *Pantry Pride* is a victory for shareholders, it is clear from the court's opinion that most defensive tactics are protected by the business judgment rule. Significantly, the court approved the adoption of poison pill plans and selective repurchases, even when implemented simultaneously. As long as the response is reasonable in relation to the threat, the directors' decision will not be second-guessed, even when it does not prove as advantageous as originally thought. However, *Pantry Pride's* chief significance lies not so much in the validity of the chosen defensive strategies but rather, as the court indicated, in the board's actions after it was no longer in the position of a target corporation fending off an unwanted suitor. Therefore, *Pantry Pride* should not be considered detrimental by target corporations plotting defensive strategies. If anything, *Pantry Pride* strengthens a target's position in adopting and implementing such strategies.[155]

D. *The Evolution of Unocal*

In light of the predisposition toward giving directors relatively wide discretion to adopt whatever means are reasonable in the face of a hostile tender offer, the supreme court's decision in *Unocal* is certainly not surprising. Nor is the decision without precedent in Delaware. Since *Cheff*,[156] Delaware courts have sustained greenmail transactions, admittedly a selective treatment of stockholders, as long

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85-90 and accompanying text) on the ground that *Enstar* involved only one genuine bidder whose participation would otherwise have been lost. *Id.* In the present case, however, there were two bidders, and the bidding effectively came to an end with the granting of the lock-up. *Id. See* Mobil Corp. v. Marathon Oil Corp., 669 F.2d 366 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982).

154. *Pantry Pride*, 501 A.2d at 1250. Even if the lock-up arrangement was not invalid because of its inhibiting effect on competing bidders, the no-shop provision surely would have compelled the same conclusion since, by its very terms, it foreclosed consideration of any other bids.

155. The Supreme Court of Delaware's affirmance of *Pantry Pride* seemed to portend the outcome of Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985), in which the court upheld the validity of the poison pill under the business judgment rule. *See supra* notes 91-99 and accompanying text.

156. *Cheff*, 199 A.2d at 548.

as there has been a rational business purpose for doing so.[157] If it is true that the practice of paying greenmail protects only the interests of the target corporation's incumbent management and unfairly allocates the target's premium to the greenmailer,[158] it would appear that such payments could not withstand judicial scrutiny under either the business judgment rule or the primary purpose test. Yet the practice has not been seriously questioned under either of these standards.

A selective tender offer such as the one utilized successfully in *Unocal* is in actual operation little different from a greenmail transaction. Both involve disparate treatment of shareholders, albeit in different form. Consequently, it is only a small step from authorizing greenmail payments in *Cheff* to sustaining the repurchase of shares from all shareholders save the raider in *Unocal*. It would indeed be difficult to find any reasonable distinction between the two actions which would invalidate the selective tender offer but authorize greenmail. In sustaining the selective repurchase in *Unocal*, the supreme court merely extended *Cheff* to its next logical step.

The court simply followed the trend in recent Delaware decisions of upholding defensive measures where the primary motive for those actions was not the retention of control.[159] In large part this trend has recognized the precarious position of a director in discharging his duties to the corporation. The decisions also underscore the importance of having a majority of outside directors on the board, thereby strengthening the presumption of sound business judgment. Therefore, absent a flagrant abuse of directorial judgment, it appears that a board's decision to fight a hostile takeover attempt with its own ammunition will be tolerated.

III. *UNOCAL'S* PRECEDENTIAL VALUE

While *Unocal* is significant in that it adds another weapon to a target corporation's ever-expanding defensive arsenal, its precedential value to future targets seeking to employ a self-tender offer may be limited. In upholding the selective tender offer in this case, the supreme court focused on a number of factors which may not be present in all hostile takeover attempts.

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157. *See supra* note 68 and accompanying text.

158. *See* Dennis, *supra* note 5, at 282.

159. The court expressly indicated its disagreement with the idea that directors should abdicate their positions merely because a hostile tender offer has been made.

First, the court considered the Mesa tender offer itself. In the front end, Mesa offered $54 cash per share for 64 million shares of Unocal common stock.[160] Shareholders not tendering their shares to Mesa or whose shares were not purchased would be cashed out with a package of securities supposedly worth $54 per share.[161] However, as previously noted, the securities to be offered in the second step merger were highly subordinated.[162] The court's recognition of the inherently coercive nature of two-tiered front-end loaded tender offers was an important element in its conclusion that the defensive selective tender offer was valid.[163] Second, the court found that the tender offer was launched "by a corporate raider with a national reputation as a 'greenmailer.' "[164] Finally, Mesa, in addition to being the author of a hostile tender offer, was also a stockholder. The court stated that while nothing precluded Mesa as a stockholder from acting in its own interests, it had done so in a manner which was determined to be contrary to the best interests of Unocal and its other shareholders.[165] As a result, the corporation had no obligation to guarantee a benefit (here, the ability to sell one's shares back to the corporation at a premium) to a shareholder who had deliberately provoked the danger to which the directors were responding.[166]

Thus, for a selective tender offer to be successful in not only defeating a hostile takeover attempt but in receiving the protection of the business judgment rule, it appears that the strategy must be adopted in the face of a coercive two-tiered front-end loaded tender offer by a raider who is also a stockholder of the target. Indeed, in the absence of these factors, a selective tender offer serves no rational purpose.

Unocal, 493 A.2d at 955 n.10. *But see* Easterbrook & Fischel, *supra* note 125.

160. Prior to Mesa's tender offer, the trading pride of Unocal stock ranged between $27 and $40 per share. Answering Brief of Plaintiffs Below—Appellees at 1, Unocal Corp. v. Mesa Petroleum Co., 493. A.2d 946 (Del. 1985). Apparently, Unocal's market price in 1984 did not exceed $41 until Mesa began purchasing the stock. Its all-time trading high was $56 in 1980. At the time Mesa commenced its tender offer, the stock sold for $46 per share. Plaintiffs' Opening Brief in Support of their Motion for a Preliminary Injunction at 32, Mesa Petroleum Co. v. Unocal Corp., No. 7997 (Del. Ch. May 13, 1985).

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

162. *Id.* at 949-50.

163. "It is now well recognized that such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction." *Id.*

164. *Id.*

165. *Id.* at 958.

166. *Id.*

A raider who does not own shares in the target corporation is not likely to be deterred by the mere fact that the target is making a higher offer for the desired shares.[167] In such a situation, the target is in the same position as any third party making such a bid. Because the raider has no investment to lose, he will either increase his offer or drop out of the bidding altogether. These alternatives exist regardless of the identity of the third party.[168] Should the raider opt out, there is no longer any need for the target to repurchase its shares.

Similarly, the strategy is ineffective against an any-and-all bid made by a raider. In an any-and-all bid, all tendering shareholders receive the same consideration for their shares because the raider is buying all the shares.[169] In this situation, one of the most important validating elements is missing: there is no coercive, two-tiered front-end loaded tender offer from which to protect shareholders. There can be no legitimate fear, as was present in *Unocal*, that shareholders will be coerced into tendering their shares out of concern that they will be cashed out in a second step transaction at a lower price or forced to accept highly subordinated debt securities. Consequently, there is no need to implement a selective tender offer because there is no back-end merger at a lower consideration.

Finally, the implication in *Unocal* that Mesa was seeking greenmail simply will not be present in the vast majority of tender offers, whether two-tiered front-end loaded or otherwise. The court found that Mesa's previous takeover activities justified a reasonable inference that greenmail was Mesa's ultimate goal.[170] With few exceptions, tender offerors will not have the reputation of greenmail artists and the reasonable inference permitted in *Unocal* will be absent.[171]

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167. Witness, for example, the scenario played out in the Pantry Pride-Revlon skirmishes. *See supra* notes 130-155 and accompanying text.

168. *See* Greene, Lewkow & Dupler, Unocal *May Have Limited Impact as Precedent*, L.A. Daily J., June 11, 1985, at 3, col. 4.

169. E.g., Pantry Pride-Revlon. *See supra* notes 130-155 and accompanying text.

170. Notwithstanding Mr. Pickens' protestations to the contrary (*see* Plaintiffs' Opening Brief in Support of their Motion for a Preliminary Injunction at 8-9, Mesa Petroleum Co. v. Unocal Corp., No. 7997 (Del. Ch. May 13, 1985)), the chancery court observed that Mesa had reaped immense profits from its takeover activities in the past few years, although unsuccessful in acquiring any of the targets on an unfriendly basis. Mesa Petroleum Co. v. Unocal Corp., No. 7997, slip op. at 15.

171. Even if greenmail is in fact a particular offeror's ultimate goal, a target corporation will not be permitted this inference unless the raider has such a reputation or has made his intentions clear that greenmail is what he is seeking. Not too many raiders will be so open regarding their motivations.

III. CONCLUSION

Any defensive tactic adopted by a target corporation, whether as a reaction to a hostile takeover attempt or as a cautionary measure, is sure to engender a lawsuit by a disgruntled shareholder or suitor. The Delaware courts, through application of the business judgment rule and the primary purpose test, have granted boards of directors fairly wide latitude in carrying out their duties, including responding to an unsolicited tender offer. Consistent with the current trend to sustain various types of defensive actions, the Supreme Court of Delaware has added the selective tender offer to the list of options available to a target corporation. This is not to say, however, that a target seeking to dissuade a raider may always implement a selective tender offer and avail itself of the protection of the business judgment rule. Absent extenuating circumstances similar to those in *Unocal*, the tactic may be rejected. *Unocal*, while currently a welcome addition to a target corporation, may prove true the old adage that appearances are deceiving.

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