We say the shareholders themselves can play around with the bylaws, but they cannot initiate and adopt a charter amendment. Even though it is an organic document and part of their basic contract, they have to run that one through the board of directors.

It seems to me some of the problems would be resolved.

Now, I am not naive enough to think that by giving stockholders the right to initiate charter amendments that that wouldn't itself cause some problems and disruptions, and one can analyze what that does to management and management's expectations and so forth. But I find it at least fun to think about what would happen if we gave shareholders the right to initiate it.

Because, remember, shareholders have to do a proxy statement too. Just as management has to convince the shareholders that Section 102(b)(7) protection is good, shareholders would have to convince other shareholders, in response to management's opposition, that removing such a charter provision would be good.

I think *Unocal* has played an important role. I happen to think it is a good decision. I am not sure I like *Time Warner*. But I know I don't like the *Unitrin* decision with its substantive coercion concept.

One of the things that comes out of this, again, I think, is that under our corporation law, we trust the board, but we don't trust the shareholders except at the ballot box, and I wonder why.

PROFESSOR REGAN: Okay. Thanks, Craig.

MR. LAZARUS: Thank you very, very much.

We are running a little late. We will take a five-minute break and then reconvene for the next panel.

III. CONFLICT TRANSACTIONS

Presenter

Lewis H. Lazarus, Esquire
Morris, James, Hitchens & Williams LLP

Commentators

A. Gilchrist Sparks, III, Esquire
Morris, Nichols, Arsht & Tunnell

Elizabeth M. McGeever, Esquire
Prickett Jones & Elliott

MR. GALLAGHER: We will be hearing from the next distinguished panel, all three of whom are practitioners before the Delaware courts. The main presenter, who has prepared a paper for us that is in the materials, is Lewis Lazarus. Lewis is a partner with the firm of Morris, James, Hitchens & Williams LLP.

The panel members with him are Betsy McGeever, who is a partner with the Wilmington firm of Prickett, Jones & Elliott; and Gil Sparks, who is a partner with Morris, Nichols, Arsht & Tunnell.

All three regularly appear before the Delaware Court of Chancery in corporate law cases. All three have spoken and authored materials on Delaware corporate law subjects. All three are currently members of the Council of the Corporation Law Section of the Delaware State Bar Association, which Gil Sparks has served as chairman. And without further ado I turn it over to Lewis Lazarus.

MR. LAZARUS: Thank you very much, Hank.

Let me first say that it is an honor to appear here as a presenter, following such a distinguished group of previous presenters and panelists.

The topic for our discussion is conflict transactions, and the theme of this whole conference is standards of review.

For purposes of this discussion, by conflict we are focusing on circumstances where a director stands in a position different from the company and its stockholders because he or she has a personal interest in the transaction with the corporation.

For example, the company is seeking to buy assets that the director owns or the company is going to pay to the director consideration not shared by other stockholders.

My topic emerged from knowledge that I had as a planner of this conference. I knew that I would follow a paper and a presentation by former Chancellor Allen and also by Chancellors Strine and Jacobs.

I knew also there would be a learned paper from Professor Regan, so I thought there would be a lot of theory, or in Larry's phrase deconstruction, and I thought that I as a practitioner could best advance the discussion by looking at what the Court of Chancery and the Supreme Court actually do and say in cases where they are called upon to review a transaction with at least one conflicted director.

I narrowed the paper even further by looking at such transactions in the context of a motion to dismiss.

And this interested me, particularly as a defense lawyer, because the motion to dismiss stage and the outcome of motions to dismiss tells you what the court believes is required to state a claim, and to permit the plaintiff to seek, and require the defendants to endure, discovery and possibly a trial.

Again, from the point of view of this seminar, one of the questions we are asking is, what purpose does a standard of review serve, and what difference does a standard of review make in practice.

My plan today is to share with you what I learned from my review of the cases, to alert you to some of the interesting developments as they relate to specific conflict transactions, such as cash-out mergers, and then broaden the discussion with our panelists by raising issues germane to conflict transactions, and, in particular, to discuss the distinction that was hinted at earlier between transactional liability and individual liability in specific contexts and then if we have time to open it up for questions.

Let me sum up by saying that I agree with Professor Regan, it is a very good exercise to have to write a paper and actually read all of these cases that have accumulated over the last 20 years since *Weinberger*.

Let me state at the outset what I learned and that is that the over-arching policy of the Delaware courts is that business decisions made by independent decision makers will be respected unless they are so far off the mark as to constitute a badge of fraud, in the words of, I think that was in *Smith v. Van Gorkom*, or to be explicable solely on the grounds of bad faith, what somebody referred to today as funny business cases.

And this is what the business judgment rule standard of review accomplishes. As a standard of review the business judgment rule requires a plaintiff to prove gross negligence, which is fairly difficult in most cases when you think about it because how are you going to know what the board saw or didn't see or what it did or what it didn't do prior to making a decision.

Or a plaintiff can attack the independence of the decision makers or they can plead waste or nondisclosure.

If a plaintiff cannot make these allegations then the complaint is subject to dismissal and the transaction is effectively immune from further judicial review.

Thus, the standard of business judgment review implements Delaware's policy of respecting business decisions of independent directors.

This has the virtue of promoting certainty for practitioners and clients, and also of reducing transaction costs.

It follows, then, that the courts are in a different position vis-à-vis this policy when the transaction under attack is one where one or more of the decision makers has an interest or is a controlling person.

That is because the courts, as we have heard today, are understandably concerned that the interested person may have exercised too much influence and caused a transaction to go forward that benefited the interested director at the expense of the stockholders.

Or, in the words of Vice Chancellor Jacobs earlier this morning, it is not a market tested, it is not a market transaction.

Thus, a higher standard of review will apply if the plaintiff makes well-pleaded allegations that a transaction is with an interested party, on terms that benefited the interested party at the expense of the corporation and its stockholders, and was not approved by independent decision makers, be they at the board or shareholder level.

That introduction leads into the cases that are discussed in the paper that is in your materials. If the plaintiff can demonstrate that a higher standard of review applies, defendants will have a hard time dismissing the complaint at the motion to dismiss stage, but they may still do so if the record before the court permits it to conclude that disinterested shareholders approved the transaction.

Let me go into that in some detail.

Let's start with the subject matter of cash-out mergers. When I started reading these cases I was thinking about titling my paper "What is Left of *Weinberger*," at least in the context of the statement in *Weinberger* that hereafter for cash-out mergers, the exclusive remedy for stockholders is appraisal, but that title was already taken by Paul Regan.

Well, for those of you who don't practice in this area routinely, if *Weinberger* is the first care thing you read and you are representing a plaintiff who has been merged out and you say, well, I guess all he has is appraisal, you haven't read far enough because the law has come a long way since then.

And in fact, really, as the two cases that are cited in the materials, the *Wood* case from Chancellor Chandler and the *Andre v. Blount* case by Vice Chancellor Strine and some others make clear, if you can allege—and again think about a cash-out merger, it is a controlling stockholder who is cashing out the shares that the stockholder doesn't already own. It is classic self-dealing, self-interested transaction because as the purchaser, the controlling stockholder wants to acquire the balance of the shares at the lowest possible price.

To the extent that he or she is a director on the corporation whose shares are being acquired, the duty to the stockholders is to get the best possible price in that transaction.

And what the courts have said is that where a plaintiff can allege that that transaction, that the defendant stood on both sides of the transaction, as they generally do in cash-out mergers, that the merger was timed so as to minimize costs to themselves at the expense of the stockholders, and they failed to provide any method for determining whether the merger was entirely fair to the stockholders, independent of the defendants themselves or their financial advisers whom they hired, that will state a claim, and you will not be limited to appraisal.

And that's exactly what Chancellor Chandler held in the *Wood v. Best* case. And Vice Chancellor Strine held similarly in *Andre v. Blount*. And

to put a point on this, if you make the argument as a defendant, faced with allegations like that, that the complaint must be dismissed because appraisal is the exclusive remedy, you may well be met with sanctions as happened in one recent case, because the law is so clear that that is no longer the case.

MS. McGEEVER: Lewis, was that ever the case? You have it said in *Weinberger*, 20, 18 years ago. But did it ever become the case? It seems that that was a statement by the Supreme Court that never actually came into play.

MR. LAZARUS: Well, the Court of Chancery applied that standard in the *Rabkin* case shortly after *Weinberger* but the Supreme Court reversed the dismissal in its review of that decision.

MS. McGEEVER: We have it now in *Unocal Exploration* with a ninety percent stockholder, right?

MR. LAZARUS: Yes, and in the case of a short-form merger, I did want to make that point, that that doctrine still is alive in the case of a short-form merger as was decided by Vice Chancellor Lamb in the *Unocal Exploration* decision that's mentioned in the materials that is currently on appeal and ready for decision by the Delaware Supreme Court.

And in that case Vice Chancellor Lamb held that there is no dealing in a short-form merger, a short-form merger being one where the stockholder owns at least ninety percent of the stock and by statute under Section 253 has the right simply to merge out the stockholders and the sole remedy there is appraisal, and the rationale, again, that Vice Chancellor Lamb used for maintaining vitality of at least that part of *Weinberger*, but in the context of a short-form merger, was that there is no dealing that is required, so there is no entire fairness, and also there is a statute, Section 253, that permits this.

So it is a very good point.

MS. McGEEVER: Any prediction on what the Supreme Court is going to do?

MR. LAZARUS: No, I don't have any prediction on what the Supreme Court is going to do, except make a very judicious decision.[2]

A second class of cases which I found interesting, the interested merger transactions where entire fairness applies, but the case is dismissed at the motion to dismiss level because the transaction was ratified by noncoerced, fully-informed shareholder vote.

And a case to look to for guidance in that area is the *Harbor Finance* case which is mentioned in the materials. That was a decision by Vice Chancellor Strine, and appears in the materials at page 10.

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[2]The Delaware Supreme Court subsequently affirmed in *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001).

But what I found interesting was that there was a derivative claim that the defendant sought to dismiss on the grounds that a majority of the directors were disinterested, and the court found that was not true, a majority of the directors were not disinterested, and so the derivative claim was not dismissed, but the case nonetheless was dismissed under 12(b)(6) for failure to state a claim because the transaction had been approved by stockholders in a fully-informed, noncoerced vote.

Let me just read you the language of Vice Chancellor Strine because I think it is very instructive and foreshadows what was in the paper that was presented by the Chancellors this morning.

"If fully-informed, uncoerced, independent stockholders have approved the transaction, they have, it seems to me, made the decision that the transaction is a fair exchange. As such, it is difficult to see the utility of allowing litigation to proceed in which the plaintiffs are permitted discovery and a possible trial, at great expense to the corporate defendants, in order to prove to the court that the transaction was so devoid of merit that each and every one of the voters comprising the majority must be disregarded as too hopelessly misguided to be considered a person of ordinary sound business judgment."

"In this day and age in which investors also have access to an abundance of information about corporate transactions from sources other than boards of directors, it seem presumptuous and paternalistic to assume the court knows better in a particular instance than a fully-informed corporate electorate with real money riding on the corporation's performance."

And with that mind set, the court dismissed the claim for failure to state a claim.

The *Solomon* decision, which was approved by the Supreme Court and was also cited in materials, makes a similar point, and, again quoting from the Vice Chancellor, "Put simply, so long as the shareholder vote to approve or disapprove the transaction was made on a fully-informed, noncoerced basis, that vote operates *ex proprio vigore* as an independent foundation for the application of the business judgment rule."

Let me turn now to a different context and that's transactions negotiated by a majority stockholder.

Once upon a time it was thought that where a majority stockholder negotiates a deal with a third party for the sale of the majority stockholders' interest and the same deal is made equally available to the minority stockholders, then the minority stockholders ought not to have anything to complain about, because you could count on the majority stockholder to act in his or her own best interests to get the best possible deal, and if that deal was also made available to the minority stockholders, then where is the beef.

That is probably still true unless the plaintiff can allege that the majority stockholder may have had some reason to sell that would have caused the majority stockholder to sell for less than the best price available, and there was no independent review or evaluation of whether the price the majority stockholder bargained for was, in fact, the best price.

That's the *McMullin* case. This decision has been criticized by some, but even the critics note that at the end of the day, unless the plaintiff can really prove after trial, or at least on a fuller record, that the motive of the majority stockholder in fact caused it to forego consideration otherwise available, it would probably not prevail.

MR. SPARKS: Let me just pause on that. I am not going to reargue that case, but you might wish to juxtapose that decision with the decision of the Supreme Court, which heretofore had been unchallenged and was not expressly overruled or even addressed in the Supreme Court's opinion in *Sinclair v. Levien*, where motive was irrelevant in the circumstance of a majority stockholder causing a subsidiary to pay a large dividend because the majority stockholder had a particular need for cash, and in that circumstance the Supreme Court said, because everybody was treated equally, notwithstanding the majority stockholders' motive, the business judgment rule applied.

And Professor Hamermesh has written an article, the title which was . . .

PROFESSOR HAMERMESH: "What is Left of *Sinclair*?"

MR. SPARKS: I think all of you may take that as a rhetorical question and think about it.

MR. LAZARUS: Which does drive home an important point, and that is the distinction between what happens at the motion to dismiss stage and after trial.

And in the *Parnes* decision, which is cited in the materials, the Supreme Court reversed a decision by the Court of Chancery, dismissing claims attacking the fairness of a merger transaction, and expressly noted that the result they reached at that stage, the motion to dismiss stage, was dictated by the standard applicable for a motion to dismiss.

And the case eventually went to trial, and Chancellor Chandler, in an opinion that apparently came out in February, dismissed all of the claims after trial as being unsupported by the evidence.

There are other cases that are in the materials that I won't dwell on at this point. We have two very distinguished practitioners here with me on the panel, and I thought we could begin a discussion that goes beyond the motion to dismiss stage and touches on some of the significant issues that are involved in conflict transactions.

One of the things we want to focus on is the distinction between transactional liability and individual liability. And I think that's an important

distinction. And what we would like to do is talk about, in the first instance, transactional liability, and break it down into the context in which this might appear in a conflict transaction.

First, you have a merger with a controlling shareholder. Then you have another kind of transaction other than a merger with a controlling shareholder.

You have a transaction not with a majority stockholder but where a majority of the board approves the transaction, and then you have a transaction not with a majority stockholder but approved by disinterested directors but less than a majority.

So why don't we start with that breakdown. Gil, do you want to pick up at this point?

MR. SPARKS: Why don't I pick up? Actually, I think you can break this down into perhaps as many as six iterations.

I did not have the opportunity, as many of you did, to sit and hear the presentation this morning of the paper presented by two of our Vice Chancellors and by former Chancellor Allen, but I think some of this plays in a little bit to that.

But before expressing my views, I would like to make an editorial comment. I think that paper and the process that it is initiating is going to prove to be a very significant one. It is a very interesting dynamic to have sitting judges and a former chancellor in effect initiate a public dialogue with the Supreme Court, outside of a case context, looking toward a synthesis and a simplification of our law. I share with the authors of that article, and I think it will become apparent in just one example here why, a view that our law, which has grown so dynamically and vigorously over the last fifteen years, has done so at the price of a fractionalization and compartmentalization of the law into a bewildering number of subcategories that make it difficult to plan. I think it is time to step back and look where we are, and I think what we are going to see is that paper responded to and at times present itself in decisions by the Supreme Court.

I am looking forward to what I think will be a dynamic and exciting process which you all have been here for the very initiation of, and I was happy to hear secondhand that the Chief Justice seemed to be receptive to that process, because I think our chancellors have a unique role whereby they are a bit more than just judges; they are also scholars and people who have a feeling of responsibility in terms of running and overseeing a competent and consistent common law corporate law system.

And in a system like ours, which unlike that in the Model Act states, is not statutorily oriented, we perhaps need this extra tool to allow our law to continue to advance.

With that background, to return to the substance, as I see it there are perhaps six different types of transactions in our law which invoke varying standards of review.

This is a little bit different from a simplification that was offered in the paper where the authors are saying, let's get rid of what they call entire fairness light and have only entire fairness, *Unocal* and business judgment rule, a proposition which I completely agree with.

This topic deals with the bewildering nature of the present triggers as to how you get into these various standards of review.

The first is a merger with a controlling shareholder. Assume that you have a merger with a controlling shareholder, and it is approved by a special committee. We know on that one that we have, under *Kahn v. Lynch*, entire fairness, burden shift to the plaintiff, and the fact that if the committee is a well-functioning committee, their approval and negotiating work is strong evidence of fairness.

Then we slip from that to a transaction, nonmerger with a controlling shareholder. My understanding with respect to that is that if a majority of the board of the subsidiary are affiliated with the parent, you get the same result. You don't get the business judgment rule. As in the case of a merger with a controlling shareholder, you get entire fairness light.

There is a third scenario which hasn't directly been addressed, and that is the fact pattern in *Puma v. Marriott*, a case which is dear to many of our hearts, but which many of us fear is becoming like a dinosaur. We are not sure if it still stalks the earth or not.

MR. LAZARUS: What is left of *Puma v. Marriott*?

MR. SPARKS: What is left of *Puma*?

Puma is a circumstance where we are not dealing with a special committee, but we have an absolute board majority, five independent directors on a nine-person board approving a nonmerger transaction with what appears to be a family of controlling stockholders who had forty-five percent of the outstanding stock, and certainly in modern jurisprudence would be considered to be controlling stockholders. The Court of Chancery said there that the business judgment rule applies.

MS. McGEEVER: But, Gil, *Puma* was a decision after trial.

MR. SPARKS: I don't think the standard is any different. The question at trial in that case would be, were they independent or weren't they independent. So if you have the same fact pattern and could only plead a conflict on behalf of four of nine directors, the question is does the business judgment rule apply if the transaction with the controlling stockholders is approved by all five outside directors. Answer, who knows?

Do you go to the special committee, majority stockholder nonmerger rule? Or is there something better about having an absolute board majority,

albeit having a controlling stockholder who theoretically has the power to change the composition of the board?

The next and fourth scenario is a transaction in which a board majority is interested, but there is no controlling shareholder. In that iteration it is my understanding that the business judgment rule applies if it is approved by a special committee.

The fifth scenario is a transaction with one or more but less than a majority of the board, no committee, no controlling shareholder, and approval by an absolute majority of nonconflicted directors. I believe you will find that's a business judgment rule.

And then the sixth one, and the most fascinating, and you will say maybe this never comes up, but I am aware of three cases decided in the last year and a half where it has come up in this situation:

Transaction in which at least one member of the board is interested, no committee, and it is approved by a majority of disinterested directors, constituting less than a majority of the directors in office.

What result? Well, let me tell you how our Court of Chancery appears to have come out on that question, and then let me suggest a couple of hypos and then let me suggest how we might want to deal with this in the future.

I have got some of these chancellors who decided these cases ten feet from me, staring at me, but, nonetheless—

VICE CHANCELLOR STRINE: We are not sure of the answer either.

MR. SPARKS: There is *Chaffin v. GNI Group*. This one I think is fairly characterized as a holding, by Vice Chancellor Jacobs.

And you might want to write this down because these get pretty complicated. It is like playing math games.

Five directors on the board, with two interested. The disinterested directors split two to one on whether the transaction ought to go forward, with two voting yes, one voting no. The two interested vote for it. So you have a four to one vote.

So you needed the vote of two of the interested directors in order to get the three out of five to have valid corporate action. Held, no business judgment rule.

Implicit in that case is that when you interpret the words used in Section 144—"a majority of the disinterested directors"—and I will get to 144 in a second because it is a troublesome overlay, and my thesis will be that every time our courts look at 144 and try to figure out whether the business judgment rule applies, they are making a mistake, it leads to mischief.

The trouble is nobody has ever drilled down to whether that language means one director on a nine-man board, eight of whom are interested, and

she votes yes. Is that approval of a majority of the disinterested directors? Or do you mean approval of a majority of disinterested directors that constitutes a majority of the whole board? That's the big problem.

Chaffin suggests, implicitly, that disinterested means an absolute majority of directors, at least, that are disinterested. That's the way I read it.

Or, in other words, if the vote of an interested person was required in order to have corporate action at the board level, you don't get the business judgment rule. I happen to agree with this case. That's *Chaffin v. GNI Group*.

Now, to be fair to Vice Chancellor Jacobs, the holding in the next case I am about to describe is an alternative holding because there seemed to be other ways in which the court talked about approving this transaction.

This is *Encore Computer Corp. Chaffin* was decided on September 3, 1999. *Encore* was decided on June 16, 1999. Four-man board, two interested who abstained, quorum being present. And the transaction with the interested directors passes by a two to nothing vote of the disinterested directors. Held business judgment rule.

I don't agree with this, for reasons which I will mention in a moment. Here, here you ended up in a circumstance where technically you had a quorum present, although two of the four didn't vote, but if you had looked at this and said, could a board, all of whom voted, have approved this transaction, the answer under *Chaffin* would have been no.

Think about what the result suggested in *Encore* means in terms of circumstances where people who are interested deliberately absent themselves from a meeting or otherwise take action which would allow lawyers to turn interested transactions into disinterested transactions for review purposes by manipulating who does and doesn't vote.

MR. LAZARUS: Gil, just stop for a second.

MS. McGEEVER: Not that that doesn't already happen.

MR. SPARKS: Not that it doesn't happen, but you have to ask yourself the question.

MR. LAZARUS: Isn't that consistent, I mean that's consistent with what I got out of all of these cases which is what I think that the court found there was that the decision makers in the *Encore* case—I mean, I grant you, the express issue of was it a majority, absolute majority of the board versus less than absolute majority of the board was not discussed, but I think the flavor of that case was the decision on the transaction was made by people who were genuinely independent and, therefore, that was a decision that ought to be respected.

Now, whether or not we should say, well, that only applies where a majority of the board is disinterested is an interesting question, but I mean the fact of the matter was in that case I don't think there were facts pled that

questioned the independence of the two directors who actually made the decision.

MR. SPARKS: No, I think that's right and I don't think there were. I think the question that it raises, though, is when we say, as does the proposal in the paper submitted by Chancellor Allen and Vice Chancellors Jacobs and Strine, that we are in search for an independent decision-making body upon whom we can rely, whether that be the directors or whether that be the stockholders, ask yourself the question whether two directors on a four-man board, not constituted as a special committee, meets that criteria. I think you can come up with a rationale which could be defended that would say had this hypothetical case that I just dealt with a moment ago posited the two independents as a special committee, as distinguished from just being two members of a four-member board where the two interested directors decided to abstain, there should be a different result based upon the institutional benefits of special committees with their own counsel, and their ability to deliberate outside the presence of the board members.

You could say business judgment rule for the special committee and not in the other structure, which happens to be where I come out, in part because I think the incentive to utilize the special committee process is diluted by giving business judgment rule protection in the non-committee hypothetical.

Now, the third case law result, which in my view goes too far in the other direction, is found in the second decision by the Chancellor in *Cook v. Oolie* decided May 24, 2000. That case involved four directors, two of them interested, four to nothing vote. And so in that case a difference was that the two interested people, instead of abstaining, went ahead and voted. And there it was held, consistent with *Encore*, that the two to nothing vote of the disinterested directors triggered the business judgment rule, even though the interested votes were necessary to achieve the vote of a majority.

Reference was made there to 144. But, again, the opinion doesn't drill down on what that language in 144 means. I would just take this result and ask yourself rhetorically whether you would agree with it, because the hypo that flows as a logical matter from the *Cook* case and perhaps from the *Encore* case is that if you had nine directors, eight of them were interested, the transaction passed by a nine to nothing vote, or for that matter by a one to nothing vote with the other eight abstaining, should that one disinterested vote give you the business judgment rule. That one disinterested vote under the language of 144 may well be sufficient to eliminate the common law specter of voidness. And that's fine. But a lot more is at stake when you are asking yourself whether you are also going to eliminate the common law specter of a breach of fiduciary duty of loyalty, and I would suggest that trying to take the language of 144 and looking to it for an answer to whether

or not the business judgment rule should apply is wrong. It is a different inquiry for different purposes.

Personally, I would find that to say the single director not constituted in the form of a special committee approving an interested transaction with eight other directors gives you the business judgment rule is a mistake. Assume a seven-person board, four interested, three independent, with a majority of those present, a quorum being present, required for board action. If everyone votes, then at least one interested vote is needed to carry the day. If two interested directors decide they are not going to come to the meeting, then it passes three to two. Gamesmanship.

I think to avoid all of this, if you are not going to have a committee, the better rule would be that you ought to have a majority of independent directors constituting a majority of the board approve the transaction in order to get the benefit of the business judgment rule. If not, you ought to be driven to a committee where you still ought to be able to get the business judgment rule. I would also agree with the Allen, Jacobs, Strine paper that you ought to be able to get the business judgment rule in those circumstances where you can get it now under our special committee law and also in connection with transactions with majority stockholders, including mergers, which are approved by properly functioning special committees.

So I would add this as a bit of a post-script, an additional suggestion, if you will, for simplification in an area that I think has become so complex that I question whether these nuances are picked up regularly by all practitioners, even in Delaware, much less those outside of Delaware.

MS. McGEEVER: Gil, in your first hypothetical, the eight, nine-person board, eight interested, one disinterested —

MR. SPARKS: No committee.

MS. McGEEVER: But put that one person, dress him up in special committee form.

MR. SPARKS: Well, I dress up two people in that hypothetical because there are other problems with one-man special committees.

But let's assume you had two-man special committee, yes, I think you should come up with a different result. You have a special committee that segregated itself off and considered this transaction. I think there is benefit in the dynamic of the committee that the courts can rely on.

I am not sure you can rely on a communal group of directors that meet and talk about it all together, eight views as to why we ought to do it from directors who are all interested, and one guy sitting there listening, and then all of a sudden at the end of the meeting the eight guys say, all right, we are all abstaining, Sam, you decide how it comes out.

I don't get the same feel for that that I do for a special committee with its own counsel which deliberates outside of the presence of the interested people.

I don't even get the same feel in a circumstance where the eight directors who are interested say, all right, Sam, we are going to leave the room and let you sit here and think about it and deliberate with yourself for awhile.

Nor do I get the same feeling where the seven directors, under a slightly altered hypothetical, would say we are going to leave and let the two of you talk about it for a little while.

I think the special committee is enough of an advance over that process that you can argue that there ought to be a different level of review.

But to look at 144 and say, 144 says this transaction, with the one guy approving it, is not void, to me does not lead logically to the conclusion that it also ought to be protected by the business judgment rule. That's really all I am saying.

MR. LAZARUS: So your rule then is that either where a majority of the —

MR. SPARKS: I prefer to say that it is Vice Chancellor Jacobs rule as expressed in *Chaffin v. GNI Group* and then maybe it will have a better chance of being —

A VOICE: 144 isn't too good.

MR. SPARKS: That's right. Perhaps this area is so complicated that in the rush of some of the ways that our Chancery Court has to deal with some of these things, or the inarticulate way which they are presented to the court by those of us in the bar, that it is understandable why this is complicated.

MR. LAZARUS: Well, at the end of the day, though, doesn't it come down to what is the procedural context or the structural context which ought to give the court comfort that you really have an independent decision, and where there are eight interested directors and one disinterested director, and you described it the way you did that doesn't give the court any comfort at all.

MR. SPARKS: Right.

MR. LAZARUS: But where it is a four-person board and the two people who really did anything with respect to deciding what to do, there is no influence by the other two, they do meet independently and talk amongst themselves, they do get separate advice, that gives you a different level of comfort.

Whether you are going to have a bright line rule that says that unless you have an absolute majority or you are a special committee you are into entire fairness, as opposed to some more nuanced rule that looks at the quality of the independent decision and the nature of the independent decision, I guess is what is up for discussion.

MR. SPARKS: That's right. And of course, it becomes significant at the pleading stage.

MR. LAZARUS: Yes.

MR. SPARKS: And that's, I think, that's a great concern to all of us. I think it is of concern to the court as it performs a gate keeper function, given the cost of litigation.

It is of a concern to all of us. So as you think about bright lines, it may be possible that you would end up with a concept that a pleading matter, you have to have a majority of the board disinterested to get by the pleading stage, without taking away from the defendant the opportunity to prove at trial that the way people acted was such that more respect ought to be accorded to the —

MR. LAZARUS: Decision by the minority, independent.

MR. SPARKS: And that ought to be itself evidence or strong evidence of fairness. That may be right. I am just suggesting, I don't think these cases have yet gotten to —

MR. LAZARUS: Articulate.

MR. SPARKS: —articulate all of this yet, and I do find that every time our courts veer off and start talking about 144, they get into all sorts of trouble, and it is because it is trying to stuff a round peg into a square hole. It has a different purpose.

And the trouble with it is it looks similar to the types of stuff that we ought to be thinking about when we are deciding whether the business judgment rule or entire fairness apply, but if you really look at it and look at some of its requirements, some of them, in fact, don't match up.

MR. LAZARUS: Next year's seminar is going to be, "what's left of 144?" But before we get to that, we talked about defenses to individual liability, we were talking about transactional defenses, and two defenses to personal liability, one is where the interested person does not participate, and the other is Section 102(b)(7). Betsy, you have taken a look at abstention cases.

MS. McGEEVER: I will talk about that. I just do want to make a plug for Lew's paper. If you are in the process of drafting a complaint now, read it so you can find ways of avoiding getting thrown out on a motion to dismiss.

Conversely, if you are in the process of writing a motion to dismiss, he has compiled a lot of the current cases where motions to dismiss have been granted.

Now, Lewis, in exchange for that plug, the next time I file a very well-pleaded complaint, where I am alleging an interested transaction, I am saying the special committee is tainted or there was no special committee, and I am alleging that there was inadequate, I expect you will not file a motion to dismiss because you have done the research and you have decided you are going to lose.

MR. LAZARUS: It sounded wholly conclusory to me, Betsy.

MS. McGEEVER: Anyway, there are four, at least four cases, if you are in the area of a director who does not participate in a transaction, and since they are not in Lewis' outline I will mention them.

There is a very early decision, 1961, at the Chancery Court in *Propp v. Sadacca*. There is the tail end of the Supreme Court's opinion in *Smith v. Van Gorkom* where this issue came up on a motion to reargue.

And then there are two more recent cases, both decided by Vice Chancellor Jacobs, *Citron v. DuPont*, and the *Emerald*, the very recent *Emerald Partners v. Berlin*.

Three of those four cases say that a director who does not participate in the transaction, in the voting of it or in the negotiation of it, just totally excuses himself from participation, cannot be held liable personally.

And those cases are the *Propp*, the *Citron* and the *Emerald Partners* decision.

In *Smith v. Van Gorkom*, which is the only Supreme Court opinion on the topic, the court did not decide the issue on the merits, because what happened there is the defense came up too late, it came up after the case had been tried and decided so that the Supreme Court didn't reject it on its merits but basically said that, in essence, you have waived making this defense by making other arguments and it is too late, etcetera.

But the *Berlin*, *Propp*, and *Citron* are all decisions after trial. In thinking about it, in trying to fit in this discussion with what we are talking about here today, I would think one can successfully raise this defense on a motion for summary judgment. I don't think it has to go to trial. It may be harder at a motion to dismiss stage because rarely does a plaintiff plead someone didn't participate in a transaction, yet I am still suing the person.

But certainly at the summary judgment stage it should be able to come up. And I turn to Lewis and Gil as defense practitioners to see if on a motion to dismiss stage you think you can get that one teed up.

MR. LAZARUS: Well, sometimes, my experience, sometimes the plaintiff is mistaken and they see a transaction, they see all the defendants and they name them all as defendants, and you call them up and say, look, so and so, one circumstance is where somebody has resigned and they weren't even there, which isn't the same thing as abstention, but another circumstance is, look, so and so wasn't there, he was sick, whatever it was, and the plaintiff may be willing to just dismiss on the ground —

MS. McGEEVER: What if there is some reference in a proxy statement and the proxy statement is referred to in the complaint?

MR. LAZARUS: Well, that's a good question.

The proxy statement, as a pleading matter, the proxy statement can be used—first of all, whatever is referred to in the complaint, incorporated by the plaintiff in the complaint, forms a basis of the record for the court to consider on a motion to dismiss.

In the *Santa Fe* decision, which I think is cited in the papers, the court is not permitted to use the proxy statement for the truth of the matters asserted.

If there is a disclosure claim and the plaintiff alleges it was not disclosed A, B, C, and the defendant comes back and says, yes, it was, here is the proxy statement, A, B, C, that's a permissible use of the proxy at the motion to dismiss stage.

You are not supposed to use the proxy statement for the truth of the matters asserted on the motion to dismiss.

So it is harder at the motion to dismiss stage to dismiss somebody on the ground of nonparticipation if it is not apparent from the record that the person didn't participate. So you are probably right, that it is more difficult to dismiss on that ground a person who didn't participate in the transaction if it is not otherwise so stated in the proxy statement or the plaintiff doesn't otherwise plead it, and sometimes they do and most times they don't.

MR. SPARKS: This raises a question, another issue that some day maybe our courts will figure out how to deal with.

One of the great frustrations for defense lawyers is the sort of blind complaint where you allege all of the stuff about the directors, but you deliberately don't put into the complaint the fact that there was a special committee.

And so if we talk about what pleading burden ought to apply in the case of a special committee, but if the court doesn't know and the defense can't put it in without converting a motion to dismiss into a motion for summary judgment, you have got a problem.

Similarly here, if some guy simply wasn't there, or he was dead, or he had resigned from the board six months before the transaction, yes, usually I can call Betsy or Norm Monhait or Joe Rosenthal and say, hey, this guy just wasn't there and they are going to let him out.

But if they don't do that, then what do you do in terms of getting things before the court that really ought to be before the court in any real sense, without opening up the door to making it a full-blown factual inquiry?

And maybe we ought to be looking as time goes on at some mechanism to allow these highly objective things that would narrow the scope of a case to be brought before the court in a way that doesn't run afoul, for example, of what is probably good law in terms of *Santa Fe*.

MR. LAZARUS: Well, it is lunch time. Maybe we can entertain a question or two if anybody has one. But we surely don't want to stand in the way of lunch.

MR. SPARKS: Think of all the things we didn't talk about. 102(b)(7) which we didn't get to.

MR. LAZARUS: Right.

MR. SPARKS: Ratification, which if you layer its four or five variations on top of the six or seven or eight examples that I gave, I suppose someone would tell you it created thirty possible —

MR. LAZARUS: Scenarios.

MR. SPARKS: —combinations that could work. We are at an interesting time. The law continues to change.

MR. LAZARUS: Thank you.

MS. McGEEVER: Thank you.

MR. GALLAGHER: Thank you very much. We will reconvene in one hour.

IV. *REVLON* AND DEAL-PROTECTION DEVICES

Presenter

Gregory V. Varallo, Esquire
Richards, Layton & Finger, P.A.

Commentators

The Honorable Leo E. Strine, Jr.
Vice Chancellor, Delaware Court of Chancery

Robert S. Saunders, Esquire
Skadden, Arps, Slate, Meagher & Flom LLP

MR. GALLAGHER: We have a few empty seats, but I guess they are just taking a little longer lunch, so welcome back to the afternoon session. This morning's session was certainly interesting and I am sure this afternoon's will be as well.

In your materials you have a paper prepared by Greg Varallo and his colleague, Srinivas Raju, and the subject matter for the next session is deal protection devices.

Greg Varallo is known to many of you. He is a partner at Richards, Layton & Finger, and frequently appears in the Delaware courts on corporate law issues.

He has authored numerous articles on Delaware corporate law, and has served, among other corporate law functions, as the chairman of the corporate counseling and litigation sub-committee of the ABA.

Rob Saunders, who is one of the panel members, is a partner at Skadden Arps and litigates frequently in corporate law issues and is

currently involved in a high-profile corporate law case in the Court of Chancery.

And we are privileged again to have Vice Chancellor Strine with us this afternoon, and Vice Chancellor Strine needs no introduction, but he has in his short tenure as a member of the court established a reputation as one of its hardest working and most thoughtful judges.

Before we turn to the subject matter I would just like to add my thanks to those given by Larry Hamermesh this morning to all of our presenters and authors and commentators, and, in addition, would like to thank Larry himself, who is primarily responsible for having put together such a distinguished panel of judges, academics and practitioners. Thank you.

MR. VARALLO: Hank, thank you very much.

My topic is a fresh look at deal protection devices. As we talk about it, the subtitle ought to make sense. The subtitle is Out From the Shadow of the Omnipresent Specter.

I want to begin by thanking Professor Hamermesh, my co-author and colleague Srinivas Raju, the reviewers, and the panelists.

I think the first challenge in talking about a subject like this is to make sense of what we are talking about when we talk about deal protection devices. Without delaying the topic for an undue period of time, I think it is fair to say there is no standard textbook or catalog of such devices. They tend to be fluid, adaptable and changing, and any definition is likely to be incomplete.

Standard devices include things like break-up fees, no-shop clauses and stock options. More exotic devices might include things like asset and crown jewel options, poison bridge financing or dry-up fees.

I would suggest that a working definition for today's exercise is any contractual provision which has the effect of making a transaction more likely to be consummated and less likely to be attacked by a successful interloper.

The cases and commentators have broadly approached the subject from a couple of different perspectives.

I am sure that in discussion this morning you have heard about a number of approaches, so I am not going to delay to speak for any length of time about the concepts or specifically the cases, but let me start by saying that one school of thought, which doesn't appear to be the prevailing school of thought in the cases, is that these provisions ought to be adjudicated under the so-called business judgment standard of review.

The argument goes that applying a threat or proportionality analysis to only one thread of a fabric of negotiated provisions and agreements loses the task of the negotiator and misses the fact that you are focusing on only one small part of a much larger whole.

The approach of applying the business judgment rule also gives a nod to what has traditionally been another rationale for applying that rule more broadly, and that is the institutional reluctance of courts to become directly involved in adjudicating the substance of business decisions.

The second, and apparently prevailing, approach is that found first in *Cheff* against *Mathes* and then *Unocal*, so-called "proportionality review."

Without discussing the test in detail, I think it is worthwhile noting that it was developed to address the perception by the courts that boards faced with a threat to their continued incumbency operate under a subtle form of potential self-interest—the interest in not losing the perquisites or the prestige of continuing to be a director. *Unocal* described this as the "omnipresent specter," that a board may be acting primarily in its own interest rather than those of the corporation and its shareholders.

It is, says *Unocal*, this specter which justifies even a modestly enhanced form of judicial review.

At the outset, it is often the case, however, that deal protection devices per se often do not involve the species of potential self-interest identified in the *Unocal* case. Often the target board which seeks or agrees to lock up a deal with deal protection devices will not be the continuing directors of the combined entity. Thus, in at least some of the cases in which deal protection devices are involved, the articulated rationale for applying a proportionality form of review is simply not present.

I would suggest, however, that while a flexible and often useful standard of review, proportionality review, as currently crafted and as justified in *Unocal*, may simply not make much sense in the context of reviewing deal protection devices.

My reasons for this suggestion are as follows: First, as pointed out in the cases urging business judgment review, to focus on only one small portion of a series of interrelated and complex provisions risks a result which fails to take into account the complexity of the give and take of negotiations, or, alternatively, potentially turns every preliminary injunction proceeding into a broad-ranging review of the entire negotiating history of every transaction.

Second, the nature of the threat analysis mandated by *Unocal* and its progeny simply doesn't fit well in this area.

For example, it is often difficult to say that a particular deal protection measure is responsive to some particular threat to corporate policy and effectiveness, except in the broadest sense that the corporate policy threatened is the completion of the merger.

To say as much, however, renders the threat identification prong of *Unocal* almost meaningless, because in each case in which deal protection measures are reviewed, the threat will be identical and will require a meaningful judicial analysis.

In fact, although I can't claim to have re-read every deal protection case in anticipation of today's discussion, very few of those cases spend any time at all on analysis or identification of the threat to which the deal protection measure responds.

For example, I know of no case reviewing a break-up fee which pauses to perform an analysis of the threat to corporate policy and effectiveness to which the break-up fee is addressed.

This must mean that in the garden-variety deal protection case either the courts have decided that the threat is implicit or that a first-prong *Unocal* analysis is of little analytic utility.

It follows that if the threat is the potential threat to the merger, then the only questions left under a traditional *Unocal* analysis are whether the transaction or the piece of the transaction considered is preclusive or coercive and whether it is within a reasonable range of potential responses.

Third, it is possible that a particular deal protection device was given in exchange for something quite different. For example, a negotiator may have agreed to a deal protection device in exchange for a material adverse change provision or a looser or a tighter form of "MAC" clause. Strictly speaking, in this hypothetical there is no threat to the transaction to which the device under review would respond. Instead, the threat, to the extent that it exists, is a threat dealt with by the MAC provision.

In a literal interpretation of *Unocal*, therefore, the challenged deal protection device would not be related in a meaningful way to the perceived threat which was, in fact, dealt with by quite a different device.

Now, while I have no doubt that our able judges on the Court of Chancery could find a way to deal with what I refer to as a cross-over effect, it does point out that the first prong of *Unocal* analysis is often less than helpful in dealing with this kind of device.

In short, our critique—I say our because it is Srinivas's critique as well -- of this approach to a standard of review is that it is somewhat formalistic to require a threat analysis which either will be the same in each case reviewed or, in a narrow subset of cases, the court might need to strain to apply such an analysis.

So, all right, I can identify a problem, what is the optimal standard of review and what ought we be doing in the courts?

To begin with, when you talk about standards of review I think it is helpful to think about what would make up an optimal standard of review.

In their paper that was presented this morning, Chancellors Allen, Strine and Jacobs say as follows: "To us a reliable test of whether a standard of review is truly functional is utilitarian. Is the standard a useful tool that aids the court in deciding the fiduciary duty issue? If a review standard does not do that, if all it does is signal the result or outcome, then the standard is not functional in any analytically helpful sense."

Of course, given the direction that that comes from, I wholeheartedly agree with the Chancellors' definition of a useful standard.

I would, however, add the following: While a standard which yields a predictable result is not of great utility in and of itself, a standard should yield a predictable result in application.

Likewise, the application of the standard itself should not dampen entrepreneurial activity or risk taking. It should be flexible and not overly formalistic or rigid, which is perhaps a retread of the Chancellors' usefulness criteria, and it should take into account both the importance of the franchise and the statutory role of directors in the governance process.

Our suggestion then for a standard of review is in the form of a series of inquiries which we would have the court apply in each case in which a deal protection device was under review. Rather than a formula, our approach asks a series of policy related questions, the answers to which drive the result of the analysis.

First, we would have the court identify not whether a particular threat to corporate policy and effectiveness exists, but, instead, for purposes of setting the context of the court's review, to identify the business reason for the challenged device. What is it designed to protect or protect against? And how does it relate to the balance of the agreements which make up the overall business deal?

Second, what, if anything, did the board get for agreeing to the provision or package of provisions? And what process did it follow in agreeing to the transaction itself?

Third, what effect does the provision have on the ability of the board to continue to gather information about the underlying transaction, right up until the time the shareholders are asked to cast their votes for or against it?

Fourth, what effect does the provision have on the ability of the board to provide its frank and current assessment of the transaction to shareholders when they are called upon to vote on it?

And finally, are shareholders able to enjoy a meaningful and informed exercise of their franchise without penalty or coercion of their vote?

Where the board could show that in approving a particular measure it was addressing a corporate as opposed to personal interest, it followed a deliberate process, the challenged measure did not preclude the emergence of competing offers or the ability of the board to understand those offers, and the board was free at all times to provide its current assessment of the transaction to shareholders, and where the vote was not coerced in any meaningful way, the challenged provision would survive scrutiny.

In practice this approach would focus principally on the effect of the device on the ability of the board to be informed and the shareholders to exercise their franchise.

The court would also be free to examine as deeply as it chose to do so the interrelationship of the various provisions of the parties' agreements and the negotiating history of relevant provisions.

The standard will also call for a more case specific and textured analysis of certain devices such as break-up fees, for example. Break-up fees would no longer be constrained to a preset range. Perhaps in an appropriate case two percent of deal value is simply too high, for example, the case of the start-up company with dwindling cash reserves, which would be stripped away entirely by the payment of the fee. Alternatively, there could be a case where 3.5 percent is too low. An example might be the small deal in which there are very high expenses.

Of course, not to steal the thunder of my commentators, but there is on its face a certain sense of familiarity about what we propose as a standard. One could even argue that it was more a description of how *Unocal* is currently applied rather than a new approach to the subject.

Not being in a position to say what judges actually do when they attempt to apply *Unocal*, I can say little in response to such a criticism, if it were, for example, forthcoming from my far right.

Perhaps —

VICE CHANCELLOR STRINE: First time I have been on the far right.

MR. VARALLO: Feels good, doesn't it?

Perhaps it is true that we have done nothing more than to describe how *Unocal* is currently applied.

If that is the case, however, I would suggest to you that practice has diverged from theory and it is time to realign the two.

In theory, the court is directed to review whether the directors have identified a threat to corporate policy and effectiveness. As the Chancellors note in their paper, there has been at least one board which has failed the *Unocal* test for failure to identify adequately that threat.

In theory, it is possible that a reviewing court, most probably a court other than our Court of Chancery, could apply the test as written and conclude that even a well-accepted or standard deal protection device was subject to being stricken on grounds that the board failed to identify an appropriate threat.

While we would ask the court to make a review of what the challenged measure was designed to protect against, and how it related to other provisions of the agreements which made up the transaction, we would do so not for purposes of identifying some threat, but, instead, to set the context for the court's review, that is to help the court understand what the board was attempting to accomplish.

In short, the first prong of *Unocal* and our first test, while perhaps close cousins in the hands of a practiced jurist, are not in theory identical.

Given the apparent lack of serious *Unocal* first prong analysis in the decided deal protection cases, we suggest that this is, at least in theory, a helpful modification of the existing test.

Likewise, to be sure, the other four prongs of our test really are nothing more than an attempt to articulate the best of the policy concerns which have been identified by courts and commentators in connection with their review of deal protection cases.

Thus, the suggested standard of review becomes, hopefully, a coherent and completely articulated statement of policy, providing the court with a great deal of flexibility in its potential application.

There would be, we suggest, no uncomfortable stretching for the jurist to apply this test. Without an explicit mandate to identify a threat to corporate policy and effectiveness, the review process becomes more focused on the reality of what the board was attempting to accomplish rather than an exercise in finding a cognizable threat to support an otherwise appropriate and rational business decision.

This approach also deals with the questionable theoretical basis for the application of *Unocal* analysis to deal protection devices in situations where there is no omnipresent specter of self-interestedness.

Simply put, rather than continuing to blink at the situation where a deal protection device is used by a board—which will not be the board following consummation of the transaction—the rationale for this approach is largely divorced from a concern about self-interest, and, instead, focuses on the potential for these devices to affect the statutory allocation of power between shareholders and the board, that is, the attention to the coerced and uncoerced vote, as well as other well-articulated and understood policy concerns, and should contribute hopefully to the evolution of the well-functioning and well-informed board.

Thus, the suggested test brings the standard of review out from under the omnipresent specter of self-interest, which is, we suggest, a somewhat ill-fitting concept in all cases, and instead focuses on the bright line of well-reasoned and well-articulated policies which have developed in the last 15 years of dealing with this area of law and practice.

MR. SAUNDERS: Good afternoon. I know that I once told my friend the Vice Chancellor that I would never agree to appear on a panel like this for fear that things that I said would be held against me. It is extremely difficult for somebody raised, trained, educated by Ed Welch to actually agree to say something in public about what the law might be other than what judges have already told us the law is.

Actually, the caveat I should give is that I am going to take a position with respect to the article and the essay that Greg and Srini have written and some other things, and I don't believe in it, at least I don't believe in it until I argue it in court and then I believe in it.

VICE CHANCELLOR STRINE: And only for that moment.

MR. SAUNDERS: Only for that moment and then I reserve the right to argue that I am wrong.

With respect to the article, which I thought was fabulous, I have a number of concerns about it, though, and I will try to tick them off in a relatively coherent way.

One, I have a general concern in the law about multi-factored tests. I am a fan of doctrinal boxes, as much as they may be inconsistent and linked to a lot of difficulty in analysis. I think that it is important for Delaware courts and Delaware law to try to evolve in a way that provides regularity and expected results to people. I think that the corporations who come to Delaware count on that, and I would be afraid or concerned that evolving what we understand *Unocal* law to be into a multi-factored test would eliminate some of that.

I also have a question that I think I know the answer to from some of Greg's comments toward the end, but was not originally clear to me, which is how the courts will handle this multi-factored test in a procedural context.

Is it assumed that any time we are dealing with deal protection devices that we will apply some level of intermediate judicial scrutiny to them, so that we won't be able to get rid of cases like that on a motion to dismiss, and that we will have to go into discovery and we will have to have judges look at them?

I think it is the implication from what Greg is saying that that will happen and that we will continue not to be able to dismiss *Unocal* claims. And maybe that is the way it should be, but, as I will talk about in a minute, I have some concerns about that. And this is my general point, that we risk losing track of what I see as being the first principles behind the business judgment rule when we get into this area.

Some specific concerns that I have about some of the factors Greg has outlined are—and with the taking in mind a great deal of respect that I have for members of the judiciary who are here and the members of the judiciary who aren't here, I am not a big fan of the litigation process necessarily as a decision-making tool. It is what we all do and it is what puts food on table and it can be a wonderful thing, but it isn't necessarily the best decision-making mechanism to get to a right answer for whatever the relevant constituency is.

There are a lot of, as we have all experienced, a lot of uncertainties in litigation and I think it is unfortunate when cases can be resolved and corporate decisions can be resolved based on whose counsel tends to do a better job in that particular case or whose witnesses stand up better to cross-examination and whose witnesses are better prepared for their depositions and things like that.

I think all of those are variables that occur and arise in a litigation context. We need to recognize and acknowledge that the judicial system and the result of the adversarial litigation process that we have is not always going to be the mechanism that leads to the optimal answer, and that really what we ought to do is make sure that our mechanisms and the law of Delaware recognize that in most circumstances, as appointed by or under the statutes, that the board of directors is the body that is most likely to reach the correct decision unless you have some reason to think that they are not making the right decision.

And I do think that we have, and I think it has already been expressed today, that we have evolved already in the *Unocal* jurisprudence into a circumstance where under *Unocal* we essentially have litigation for litigation's sake. It is impossible, which is again a wonderful thing for lawyers, but it is virtually impossible to get a *Unocal* claim dismissed and as I think it has also been discussed, it is very, very difficult to ever succeed on a *Unocal* claim.

It has been suggested, for instance, that there is not a single example of the Supreme Court actually affirming the granting of an injunction under *Unocal*. So we get an awful lot of litigation that can't be dismissed and yet has very little success, very little prospect of actually leading to a result that is going to stand up.

And that concerns me. I wonder why it ought to be that we have a regime that leads to that result.

And then I hear the argument made, as I think Greg is making it and as I know some of his colleagues have made, I think Travis Laster has written a fabulous article in *The Business Lawyer* about deal protection devices, arguing, as Greg has, that, and it is a sensible argument, that this distinction that we have in the law between *Time Warner* and *QVC*, which are stock deals and cash deals, and why should it be the case that we will apply scrutiny to cash deals that we will not apply to stock deals, and I understand that that is a distinction that is questionable.

But in my mind this argument brings the reaction, and I am sure to the Vice Chancellor's dismay I haven't been able to think of the precise lyric, but there is this song from the sixties that I know I have on Freedom Rock that is "Let's tax the rich until there aren't any rich anymore."

We don't like this distinction, we don't understand this distinction between cash deals and stock deals, and so in order to avoid that distinction we are going to eliminate it and just subject everything to enhanced scrutiny, and we are going to make everything, all of these cases go through the funnel of judicial review to make sure that what the board has done is okay.

The one quote I wrote down from what Greg had to say was that he thinks that the analysis ought to be divorced from concern about self-interest and that we ought to look at these deal protection devices sort of regardless

of that, they ought to be subject to some level of judicial scrutiny to see if they are in the best interest of stockholders. That substantive judicial review in the absence of any reason to doubt the directors' motivations concerns me.

So the point I would like to make with that introduction is that in my mind it is important to go back to first principles and think about what the point of the business judgment rule is and then how that analysis ought to apply to deal protection devices.

We throw around the word defensive when we are talking about deal protection measures, and I think that it is important to break that down and figure out what is it that's being defended, and is it something that we are concerned about or not.

If what is being defended is directors and officers, with directors entrenching themselves and directors trying to preserve the perquisites and emoluments of office and all those kinds of things, then I absolutely think that that is a kind of being defensive that we ought to be concerned about—it implicates the omnipresent specter under *Unocal*, and we ought to have judges look at what actions directors have taken in the context of being defensive in that way.

But if what we are talking about defending is a deal, there is nothing in my mind about defending a deal—i.e., defending a particular decision of directors—that makes those directors' decisions suspect and outside of the normal business judgment rule analysis that we would apply to any another important transaction that directors would approve.

So I am uncomfortable with the argument that I see a flavor of in *QVC* and I have seen in various things that practitioners and academics have had to say, that because change of control transactions are important, that regardless of whether we see directors defending themselves in office, we are going to ask courts to scrutinize them, to at least some degree, and make sure that they are reasonable and make sure that they are in the best interests of stockholders.

Going back to those first principles that—informed the business judgment rule to begin with, and if he is in the room I ought to say that I have always been a big fan of Professor Regan, and I think a lot of this in my mind comes out of his Importance of Being Earnest argument, and I am a fan of Paul's not merely because he is the greatest quarter-miler in the history of the Commonwealth of Pennsylvania but also because he has written some very nice pieces on the subject —

I think that you have to sit back and say what are the reasons why we are going to take this decision away from the body that as a general matter we have reposited the power to make the decision in.

I think there are two grounds to do that. One is that you have some reason to think that their decision-making process isn't likely to lead to the best answer. That could be either because you think they have been careless

and the process that they followed is one that is not likely to lead to the best answer, or it can be because you see that they have some self-interest.

The metaphor I like to think of to explain those things is that you are throwing darts at the target, and a properly functioning board is going to take care and it is going to aim for the center, and it might miss, and we don't hold them liable for missing, as long as they are aiming for the center and as long as they take careful aim.

In this metaphor, the duty of loyalty is the obligation to shoot for the center and not to be shooting off to the side because you have some different interest.

And the duty of care is the obligation to be careful when you are throwing the dart and to prepare for that and make sure you know where the target is and what you are doing, and not just throw willy-nilly.

I think in either of those circumstances (and I don't have necessarily the same concerns that were expressed in the morning session about treating care violations differently), I think that where you can establish through pleading, and ultimately through facts, that directors have not been an adequate decision-making body because of either of those defects, that it is appropriate to take the decision-making power away from them and to have a court, through a litigation process, try to decide what is in the stockholders' best interest or to examine the directors' actions for reasonableness. I think all that is clearly correct.

The second ground on which I think it would be appropriate to exercise a check on what directors have purported to do is the question: Have they exceeded the power that they are given? Have they taken some action that we think they simply do not have the power to do? Have they invaded the territory that we think legally belongs to stockholders?

And I think it is here that I am going to argue for a difference than what has been expressed and I think probably what most people would think is embodied in the case law. In my mind this second ground raises a legal question, as distinct from an equitable question.

The legal question is: Have the directors done something that they don't have the power to do? Have they usurped authority that under the law, under the statute, under the law as it has developed interpreting the corporation code, is a power that belongs to the stockholders.

Now, what I see blurring that question is, how do you incorporate the equitable overlay, and how do you decide when have directors improperly exercised their legal power in a way that is interfering or coercing or influencing the stockholders' exercise of their right to vote on a merger transaction or their perceived right to tender to whomever they want to tender to.

The argument that I would make is that we have to start by considering the source of that fiduciary overlay. Again, it is the obligation

to act with care and the obligation to act with loyalty. By contrast, I don't understand there to be a fiduciary duty to refrain from acting in the way that you perceive as a fiduciary to be in your beneficiary's best interest merely because your beneficiary has a different view of its own interests.

I think that it is the obligation of the fiduciary in all circumstances to act in the way that the fiduciary sees as being in the best interests of the beneficiary, again, regardless really of what that beneficiary sees, because, first, beneficiaries can be wrong, and it is frequently the case that directors will have better information about what is in the best interests of their beneficiaries than the beneficiaries themselves will have; and, second (and I think this is maybe the most controversial part of what I am going to argue for), that even if we assume that stockholders are likely to know what is in their best interests, most of the time when we are talking about these things we talk about the stockholders generally, and we talk about the stockholders generally knowing what is in their best interests, and we assume that a majority vote, a simple majority vote of that educated, informed body of stockholders is going to be the best indication of what is in the collective stockholders' best interest.

And I suggest to you that an examination of public choice theory shows that when you have a variety of voters with different interests on a particular topic, a simple majority vote is not necessarily what will lead you to the optimal result that is in the interest of the voters as a whole.

Let me give you a simple mathematical example. Let's say you have two stockholders or you have a million stockholders but are generally divided into two categories, and you have say sixty percent of the stockholders who believe that the company's stock is worth $10 and they would be happy to sell it, tender it to a buyer at any price essentially over $10, and the other forty percent of the stockholders believe that the shares are worth $12.

If the decision about what the stockholders are going to do in that tender offer is essentially coerced—people have trouble with that word—but 50.1 percent of that stockholder body gets to make the decision, then a tender offer at $10 and a penny is going to win the vote, despite the fact that a tender offer at $10 and a penny is collectively not in the best interest of the stockholder body as a whole as they see it, because the sixty percent are only getting a penny over what they think it is worth, the forty percent are being forced to sell an asset for 1.99 less than they think it is worth.

So the point I am trying to make is that while I think it is true, I think it is almost indisputable that as the holdings of companies tend to be more and more concentrated in the hands of very well-educated and very informed institutional stockholders who very clearly understand what is in their best interests, even if we have the view that those stockholders are perfectly capable of figuring out what their own individual best interest is, we have to

recognize that all stockholders do not necessarily have the same view, and that permitting stockholders by a 50.1 percent vote to determine what is going to happen is not necessarily in the collective interests of the stockholders as a whole.

And that in my mind is the reason why it is important to give directors, as the fiduciaries in charge of considering the interests of the stockholder body as a whole, to be able to act in the interests of the stockholder body as a whole.

VICE CHANCELLOR STRINE: Can I ask something?

MR. SAUNDERS: Please.

MR. VARALLO: Don't I get to respond?

VICE CHANCELLOR STRINE: No, actually, I think there is a lot in Greg's paper and a lot to what Rob says.

This is a conference on standards of review and I want to sort of make I think a simple point about enhanced scrutiny.

In the corporate law I have a hard time linguistically distinguishing between the concepts of reasonableness and rationality, but the corporation law does a lot of that. And really what we take is ordinary business judgment review is rationality, wherein you have to act sort of bizarrely in order to get in any trouble, right, or we leave our hands off the directors' decision. Under enhanced scrutiny we go to the sort of traditional reasonableness review that a court would do of somebody's conduct.

And I think what complicates matters in terms of deal protections, in terms of defensive measures, is a few things about the corporation, and I think *Moran*—I couldn't agree more with Professor Regan what a central case *Moran* is. And the test I always use is what would the Chancery Court have thought in the 1950s if somebody came up with a device like the poison pill that discriminated against stockholders, that did not follow the traditional *pro rata* approach. My sense is that you would have got a very short opinion that would have blown that off the face of the earth.

And so, but, of course, we didn't go that way and I think it has turned out well. But there was a recognition in *Moran* that the adoption of a poison pill is a very different corporate action. I mean does anybody know of a company that has built its business plan around the poison pill? I mean, is that an ordinary business decision?

The wielding of a device, the only purpose of which is to prevent, arguably—we are a free market country, Mr. Saunders, I thought—willing sellers and buyers—rich people—from dealing with each other is not an ordinary business decision.

And that's the only purpose of the poison pill. And I think it has turned out well. I mean I think, frankly, the early the Chancery Court decisions, *Interco*, and the Gilson/Kraakman article, which I think if you read it stands the test of time, that the pill can be used as the gavel, that it can

be used, the board can use it to help the buyers. But it is a very dangerous kind of thing. It is a different kind of concept and *Moran* promised that it would be used responsibly and that there would be some checks on it.

Deal protection measures have to be taken in light of that, that there isn't an open market. Usually these companies have a pill in place so when you are doing a deal protection measure, a protected deal, you already have the pill, so it is not like it just operates in isolation.

And I think a lot of this discussion, again, about the overall look at the standards of review in corporation laws, turns on who makes decisions, that is, are the appropriate people getting to make the decisions? And I view the judicial role, what Delaware has tried to do and figure out over the last 20 years, is how does the judiciary police this unusual area where the power of the stockholders as owners of their particular stock, and the power of the director intersects. Bayless Manning talked about that in his article right after *Van Gorkom*. How do you police that boundary?

I would suggest that *Unocal*, while it is not perfect—I think there is a lot to what Professor Regan said—but I think it still has potency, and I think that boards of directors have actually embraced *Interco* in many ways as the operative way of going about their business.

If you look at the way transactions go down, boards will put out their favorite deal. They will use the pill. They will use other things to protect it. Often times when the market, when a different solution comes to the place and the marketplace has evaluated it, and it becomes clear that something different than what the board originally wanted to do is economically viable, the board itself as a normative matter will follow the rules of *Interco*.

And I think actually where I would disagree I guess a little bit with Rob's point about legitimacy. One of the problems is I think there is a doctrine out there which is sort of what I call republican-democratic view of the corporation, which is that you elect these people, and they ought to make the decisions and, frankly, if they can stop things in between elections, that's okay.

The problem with that is that as a practical matter I think empirically speaking the only time in which you have real corporate elections has been when there has been a tender offer on the table.

We talk about campaign finance reform in the country. We don't have a situation, as I understand it, where President Bush can use the United States treasury to run his election campaign.

But that is how corporate elections work. They are not the same as other elections, and so that is something we really haven't talked about it, and it begins to become analytically incoherent where you have a situation where you say, go to the ballot box, but the only time the ballot box is really used is when it is the functional equivalent of a tender offer. That becomes I think, at least as an intellectual matter, unsatisfying.

I think the omnipresent specter, why we don't use that, I think it is appealing to say we only ought to do these things when there is some sense of self-interest and that ought to affect the standard of review, I think actually using the reasonableness test in an appropriate way factors that in, and I will give you an example.

There are cases where stock-for-stock merger agreements are, in fact, defensive responses. And one was argued to me in a case called *United Rentals* and, in fact, it went away before the decision, but it was in fact a stock-for-stock merger agreement. The records did show —

It was a case where these two people have been talking about stock-for-stock merger agreement, they couldn't get it together, the price was wrong, bidder, you know, one of the rivals in the industry got a bunch of capital, all of a sudden two people who couldn't make it work are together, the deal protection measures jump immeasurably, the target is asking, buy me, tie me up, you know, imagery I didn't want to think about giving you in full.

But what I am saying is if you change the standard of review, if you say, I am going to look at the termination fee in that kind of case, under *Unocal*, as a specter, then every case is going to immediately, you know, dive into those motivations.

One way of looking at it would be to say in every case we will look at these things—such as the directors' interests—but we will be sensitive to the overall dynamics. If there is no specter of self-interest, that's part of the analysis. If there is a reason for the deal protection measures, we will consider that. But this is where Greg's piece, I think, is a bit of a caricature.

For example, Greg says nobody knows why or what the board is protecting when, you know, the court doesn't talk about in a stock-for-stock deal why there was a termination fee. Maybe we don't dilate on the obvious, and after *Arco* maybe we need to. But, I mean, if you have got a stock-for-stock deal your rationale is this was a good deal. In order to get this deal, we agreed with these deal protection measures. That's the benchmark.

I agree with you, we ought to just have a simple test, is it reasonable in proportion to what the directors are trying to achieve? We may need to change the nomenclature, but I think our paper indicates that's basically what the courts have been doing.

But I think you are not really articulating a business judgment rule approach. It is a reasonableness review. But you are asking us to be textured about it.

MR. VARALLO: Right.

VICE CHANCELLOR STRINE: To realize that there are trade-offs, and what I say is I think that is our job and I think that we have to be appropriately modest about stepping on directors' toes.

But I don't think we can get out of it because, again, I think we are not picking between the two deals. But what we are saying is, you know, this is important stuff, and it does affect the stockholders' ability, for example, to take a tender offer, and if it is a stock-for-stock merger agreement these stockholders have a statutory right to approve this transaction. Their agreement to the transaction has every bit as much dignity and is every much legally required as that of the directors.

And how do you go about looking at that? And I just say that I think, you know, that the *Unocal* tool is not a bad way to do it.

I would also suggest, I said this to Professor Regan, that one might ask not what is left of *Unocal* but what is left of *Revlon*. And that many of the cases, if you only look at the cases that don't involve sort of *Revlon*, then it looks like *Unocal* has gone away. But if you look at cases like *QVC* and others, there is a realm of cases about defensive measures, discriminatory treatment, barriers to emergence of empire deal, and even though the Supreme Court has not yet apparently used *Unocal*—although they did in *QVC*, remember, it is a joint holding under *Unocal* and *Revlon*—the Chancery Court has used *Unocal* on several occasions, and I would also point out that there are the "punk-out" cases which is where the people were before the board and maybe they blinked before an injunction or they thought an injunction was coming, and there are several recent examples of those.

MR. VARALLO: Very quickly, Rob began by saying he liked the notion of doctrinal boxes, and I certainly appreciate the need for a coherent and predictable body of law, but I am not a fan of doctrinal boxes. I think striving to fit transactions, in particular transactions in a number of neat little doctrinal boxes over the last decade or so has led to a terrible mess in the law.

Chancellor Chandler at last year's Tulane conference gave a speech, which I think was subsequently published, the effect of which was striving to structure your transaction as a *Time Warner* transaction, rather than a *Revlon* transaction, and doing back flips to try to drive a standard of review on an economic transaction really didn't make a lot of sense, and if our law had gotten us to the point of structuring an economic transaction around these standards of review, then maybe we needed to take a step back and think about a more coherent approach to things.

I, for one, believe that with all the talent in the room and all the talent at our bar and in New York, and the various other commercial centers, trying to come up with a series of doctrines, nice little boxes into which we are going to fit every mutation of every defense, in every transaction henceforth, is probably ultimately folly.

But I say that with due respect to my colleague. I agree with him when he says that a standard of review that looks or feels or smells like

Unocal in some way, shape or form is going to lead us to the situation we have today where you are not going to be able to get rid of these cases on motion.

VICE CHANCELLOR STRINE: Let me jump in here. I know *Santa Fe* says that. I thought, I thought *Revlon* was more intense scrutiny, and I know I got rid of a *Revlon* case this year, and I looked at termination fees, all the things you do in a *Unocal* analysis. Vice Chancellor Lamb got rid of one.

It did rely on a proper use of 102(b)(7). I agree with that. I mean, if they take away the ability of the court to say a 102(b)(7) provision is in place and you don't look at due care. I mean it is odd to be litigating *Unocal* cases or *Revlon* cases after the deal closes, I got my own views on that, but I mean, you know, it is very —

MR. SAUNDERS: What are they?

VICE CHANCELLOR STRINE: These are transactional type of concepts and they ought to be done at the appropriate time.

But I think that the Court of Chancery has tried very hard to faithfully play its gate keeper role and not let people, you know, just plead conclusory things about a process.

Because I think if all you are pleading is that there was, you know, a two percent termination fee, you know, and a no-shop clause, and that the board didn't do an adequate job shopping, if that's what you are doing, you know, I think that's going to be scrutinized very closely. I think that's a role that the court has to play. I agree it is bad economic policy to keep letting these things go forward, but I don't think it is a show stopper to a motion to dismiss.

MR. SAUNDERS: I agree with you, definitely, that there are too many boxes, and that's a bad thing, and it is too convoluted and scholastic and all the rest of it, and it would be nice to be able to organize a little bit more.

But I do think that we need to have at least one dividing line relatively clear, and that's the dividing line between what gets dismissed on business judgment rule grounds and what doesn't—that is, what gets you into discovery and judicial scrutiny.

And I think there is an important decision to be made about where that line is going to be drawn and are we going to say that any extraordinary transaction, any change of control transaction, any transaction that involves deal protection devices, is going to be on the judicial review side of that line, and it is going to be subject to some level of enhanced scrutiny or whatnot. Or are you going to be able to dismiss that on the basis of something other than mere conclusory allegations or 102(b)(7).

In my mind, and this is my argument for first principles, if we think back to why do we have the business judgment rule, whether we agree with

it or not, but what principles is it, what principles is it based on, do they apply in a transaction where you have directors who are all voting themselves out of office, who have no self-interest in the process, where there are no allegations that they have acted less than with due care, what is it about the fact that they are engaged in an extraordinary transaction and they have protected that transaction with a termination fee or a lock-up or whatnot, what is it about any of that that makes them a decision maker that we distrust?

MR. VARALLO: Well, I think that a basis for bringing to the table something other than classic business judgment review of these things, and, unfortunately, it depends deal protection device by deal protection device, but one could make the argument it seems to me, Rob, that, as the Chancellor has noted before, we are talking about interfering with statutory rights.

There is a statutory right of stockholders to vote on a merger under the code, and to the extent you do something which drives a result or makes that other than a truly free and informed exercise of that right, then maybe the courts ought to be saying, wait a minute, we are not going to be deferential, we are going to at least have some higher level of scrutiny. Call it reasonableness, call it *Unocal*, call it whatever you want. But to the extent we are affecting or impacting the statutory ability to do things I think we ought to be concerned.

Another example that comes up, which in my mind would justify a heightened standard of review, is, you know, in merger agreements today you see all the time a requirement that the board recommend a transaction unanimously and, if asked, reaffirm their recommendation, and some of them tie that provision to the payment of a break-up fee if the board is unable to unanimously reaffirm.

What a horrible idea. And what does that do—horrible idea unless I am arguing for it, of course. But what does that do to the board's duty to be in a position to give a fully informed recommendation to shareholders at the point they vote?

VICE CHANCELLOR STRINE: Well, it is great if you are a plaintiff securities lawyer because you want them to file a proxy statement doing that and try to write it truthfully, because it is —

MR. SAUNDERS: Let me give you an example.

A VOICE: What you just said was actually correct. What you are analyzing is interfering with the stockholder vote. Why is it appropriate to buy into a fiduciary analysis? Because presumably directors who are being very careful, were being very loyal, were being very well advised, and they think, gee, the best thing for our stockholders is to go back and put in a hundred percent break-up fee. The reason you can't do that is that Section

251 says that stockholders get to vote on mergers and you have taken away that right.

MR. SAUNDERS: To try to summarize a different way, I would say why is what the beneficiary says they want a factor that should go into the fiduciary duty analysis? Why should a fiduciary who is acting loyally, and who is fully informed, care about the fact that the beneficiary has a different view of what it wants?

VICE CHANCELLOR STRINE: Well, put it a different way, why should anyone, as Greg said, why would anyone have thought, who gives a, pick your epithet, what the board thinks about what I think about whether I should accept somebody's tender offer?

I mean, that is the problem. Without *Moran*, remember, the statute doesn't say you get to manage the corporation and then you get to choose for your stockholders whether they accept the tender offer.

And so I think you can't divorce these things from that reality, because that is an overlay that exists, and there is nowhere, and I know that people like Marty Lipton said that no one ever thought of the tender offer in 1967 when they did the Folk report. They weren't thinking of anything. Then why are the other things they did valid, too?

The acceptance or rejection of tender offers is not something given to the board of directors as a matter of the default laws of Delaware. And *Moran* said that if you want to get in that area, you get policed. And maybe it is a conundrum, but that's sort of where we are.

MR. SAUNDERS: I guess I would try to again break it down into a legal analysis and an equitable analysis. I can absolutely see the legal analysis saying these directors do not have the power to do what they are doing, they are acting beyond the powers that are allocated to them under the statute. But if they survive that legal analysis, and what they are doing is something that they have the power to do, why should the equitable overlay require anything more than that fiduciaries act in the best interests of the beneficiaries as the fiduciary sees it?

VICE CHANCELLOR STRINE: Because of *Moran*. *Moran* is an interesting case because it sort of ties its interpretation of the statute to this other promise. You know, it wasn't this sort of naked statutory right to discriminate willy-nilly against stockholders, you know, and to use this however you wished. It is a case that almost says we will acknowledge you can do this statutorily if you act in compliance with the fiduciary duties.

And so —

MR. VARALLO: I hate to resurrect the sometimes discredited, but perhaps still very much alive, *Schnell* case into the discussion, but the notion that merely because you have the statutory power to do something, that the court ought to leave you alone when you exercise that power, seems to me to have not been part of our law for a very long time.

MR. SAUNDERS: But you understand that's not what I am saying.

What I am saying is that if we are going to interfere with the directors' exercise of a power that they legally have, it ought to be on the basis of an equitable principle. And as I understand what their fiduciary duty is, it is everyday and every way to act paternal. They have to inform themselves and they have to be loyal. But it is to act in the best interests of their beneficiaries as they see it.

MR. VARALLO: Subject to not interfering with the statutory balance of power that is set forth in the statute.

MR. SAUNDERS: I agree. Let me give you another example, because this was, I think, a fascinating paradox that actually came up to me from one of my corporate partners, and it collapsed my neural nets for about three hours, and I think it is interesting to think about it in light of some of the things you said in your paper.

And that is imagine that you have an agreement that has—let me start off by saying I am absolutely agreeing with the expression.

MR. VARALLO: What the Vice Chancellor said.

MR. SAUNDERS: Everything everybody said. But the point is there is no way that a board can contractually obligate itself to lie, in other words, to make a recommendation as to something it doesn't recommend.

MR. VARALLO: Right, right.

MR. SAUNDERS: But the paradox is, let's imagine you have a merger that has either a very small fee or no break-up fee in terms of a naked no vote. If the stockholders simply vote it down then there is either a small termination fee or no termination fee. But in the event that the board has changed its recommendation there is a large, substantial fee.

MR. VARALLO: So is that tied to a different proposal being done?

MR. SAUNDERS: Anything. Let's say that circumstances change, you know, gold is found in somebody's backyard and whatnot, and the board is of the view that, well, it is not in the interests of the stockholders to vote for this anymore, either because that company has gone down or we are more valuable, but that difference is not as great as the termination fee that will be payable if I have to change my recommendation.

MR. VARALLO: Right, right.

MR. SAUNDERS: So let's say it is a hundred million dollars. I think if the stockholders can somehow see their way to voting no, that would be the best thing for them to do because there is no fee payable, and I don't know if it is due anymore.

MR. VARALLO: Right.

MR. SAUNDERS: But if I have to change my recommendation then I have contractually bound myself to pay the hundred million dollars termination fee. What do I do?

MR. VARALLO: Maybe I am missing something because my nets haven't gone down yet, but having thought about this recently in connection with a transaction where we had a 115 million dollar fee, in a not terribly dissimilar series of circumstances, the advice we gave was that your duty to recommend can take into cognizance the amount of the fee you have to pay, and that perhaps what you do is you say in your disclosure, which by the way winds up driving the deal coming apart, but you say in your disclosure, we are recommending this to you because, for a few reasons, one, we have a contractual duty to do it and failure to honor that contractual duty costs us 110 million dollars; second, we believe after analysis that the company is more valuable, however, it is not as valuable as, the incremental increase in value is not as valuable as the fee we have to pay. Therefore, we continue to recommend.

And, oh, by the way, we considered all these other wonderful factors that make this a synergistic and wonderful deal, and you put that disclosure out there.

And while there is an interesting question as to whether that breaches your best efforts undertaking to get the deal done, which is in each and every one of these agreements, I think, anyway, that no contract can keep you from honestly giving your reasons for your recommendation, and it seems to me that you could come to a disclosure which was sufficiently ugly for the other side that they said, okay, we —

VICE CHANCELLOR STRINE: Let me just say, I think that this discussion is a perfect illustration of what I was trying to point out, and I think what Gil Sparks made earlier, and I think Greg has made a point about boxes.

It is a great illustration about why in the end you can't, you won't be able to box away these problems. They are too complex. And why at the end of the day I think what you are still going to have is in these areas that touch on very important, significant transactions that require, that often require stockholder approval, you are going to move from a rationality level of review to a reasonableness level of review and you are going to try to look at the circumstances, you are going to try to do so judiciously, hopefully at a transactional stage where it is before you are doing any kind of monetary liability, but ultimately it becomes too complex to think that you can just segment it away, because as the marketplace evolves in these weird ways. I mean nobody was talking about these kind of thing —

MR. VARALLO: Right.

VICE CHANCELLOR STRINE: —even five or six years ago.

MR. VARALLO: What about this notion, Chancellor, that we have to identify a threat? I heard you and I understand.

VICE CHANCELLOR STRINE: You have to identify a business reason, you know, why did you do that.

MR. VARALLO: A threat to a corporate policy, and effectiveness?

VICE CHANCELLOR STRINE: But I mean why should we—frankly, the *Unocal*, it is not a bad thing.

MR. VARALLO: Slavish adherence.

VICE CHANCELLOR STRINE: I know a lot of you people say the test has failed because there is no cases that just blow the directors out on the first prong. I read the first prong as saying, okay, you were the directors, we are giving you deference. You tell us why you did something. Right. You were there. Tell us why you did it. That will be our benchmark, you know. And we are going to accord you a lot of deference. But you tell us the two or three reasons why you gave somebody the lock-ups nobody ever heard of. You know, was it that great a deal. What were your reasons. What were they demanding.

That's why I said I think it was a little bit of a caricature to say because we only focused on the arguably defensive parts of the agreement and that directors can't put in the other elements to justify their conduct.

I think that we have been trying, you know, the courts have tried to stay out of the economics because they are really talking about clearing the channels of decision making, but I mean I think that's what the first *Unocal* prong does, is it smokes out that rationale, gives the board a chance to explain.

I think part of the cases where people get caught up is they didn't do the process on the front end. I think one of the most helpful things you are saying is, you know, if you are going to give boards deference then they ought to have done their jobs in the first instance.

Their advisers shouldn't be the only ones thinking about these things, and that's where you get the bad deposition testimony, right, because the directors weren't in on the decision in the first instance, and counsel are then trying to put it in their mouth later, their speaking objections or however it was done at the deposition. It was really because we were worried about confusion.

MR. SAUNDERS: Let me, I guess, take thirty seconds to be pedantic about *Revlon*. The point I would like to make with respect to *Revlon*, and I think I have at least some degree of agreement from the colleague to my right, as much as I love saying that, is that I think it is really time to put the nail in the coffin, in that, to me, we ought to at this point in time understand *Revlon* as a subspecies of *Unocal*, and that there is nothing about selling the company by itself that provides a ground for enhanced scrutiny.

And this is the same theme, the things I have been talking about.

If you have disinterested directors who have fully informed themselves and have decided to sell the company in a transaction which has them leaving the stage, they are not entrenching themselves, they are not getting special payments, or maybe if they are getting parachutes, the chutes

are the same under all the deals that they are considering. What is it about that set of circumstances by itself that gives you any reason to want to impose the enhanced judicial scrutiny?

I absolutely understand the omni present specter, and I understand the point of *Unocal* jurisprudence, but I don't think there is anything about the *Revlon* circumstance by itself that provides a basis for enhanced scrutiny, and we ought to clean that up and recognize that, while it makes perfect sense when you are selling the company for cash to have the obligation to get the most cash you can, and as directors always have the obligation in entering into any transaction to try to get the best transaction that they can, whether it is stock or cash or whether they are hiring somebody, whatever they are doing, they always have the obligation to try to do the best that they can, but there is nothing peculiar about a sale of the company for cash that in my mind creates a basis for enhanced scrutiny.

If that sale is accompanied by defensive measures or accompanied by payments to individual directors that are different from what they would otherwise get, then, yes, that gives you the basis to take a look at it.

But the simple sale transaction by itself is not in my view a sufficient basis for enhanced judicial scrutiny and we ought to get away from it.

VICE CHANCELLOR STRINE: And I think that's an apt actual description of how the cases have been moving anyway, and why I think in a way *Unocal* has not been as sort of disemboweled as Professor Regan suggests, because I think it has just emerged in that other context.

But I don't think we, at least the auction process anymore, and I do think there are cases for defense lawyers at the dismissal stage, where plaintiffs have been under supposedly the highest standard of *Revlon*, have not been able to plead facts which state a claim.

A lot will hinge, I admit, on how 102(b)(7) is interpreted, because if it is sort of reasonableness and you can't take care out of the equation then it becomes very different.

I do want to mention, Gil Sparks said about these complaints where people have snipped, cut and snipped the proxy statement, how frustrating it is to a defense lawyer. That's very frustrating for judges too. Particularly frustrating if you have pled both a disclosure claim and the other claim, when you see a complaint that's been wholly written from a proxy statement, but you go from paragraph 1 to paragraph 4 and paragraph 2 and 3 is, of course, the two months that the special committee took.

There is something called Rule 11, and there is something called partial summary judgment, and I think that to the extent that you feel that there has been abuses I think first you take it up with your friends on the plaintiff's side and you say, hey, did that get whited out, that part, because you seem to be word for word everything else, do you want to reconsider, I think that's your first step.

I think the second step is to think about a motion for partial summary judgment on that issue. And I think, frankly, if the plaintiffs haven't used the tools at hand and they don't have some other information where they say, right, they plead that special committee never met, and they plead that, and it was a proxy statement out there that said special committee met five times, and it turns out to be no basis, I mean, the court is going to take that very seriously and, frankly, it wastes our time and you want to do justice in the cases that should be in the court.

So I think there is a tendency to think that you can never use the partial summary judgment tool or you can never come in and say we want to focus on this issue. We will give you two depositions, documents, get rid of that. And I think people have to give us credit or at least let us prove that we are not open to being case managers who will help you deal with situations in that way.

MR. GALLAGHER: I think we are about out of time for this segment. We might have time for a question or two. But if there are none we will take a break and be back?

Anyone want to throw something out?

We will take about a ten-minute break and then resume. Thank you.

V. INTERFERENCE WITH VOTING RIGHTS

Presenter

David C. McBride, Esquire
Young, Conaway, Stargatt & Taylor, LLP

Commentators

Lawrence A. Hamermesh, Professor
Widener University School of Law

Norman M. Monhait, Esquire
Rosenthal, Monhait, Gross & Goddess, P.A.

MR. LAZARUS: It is now time for the last segment of our discussion this afternoon, and that's the section on voting rights and the standard of review. Voting rights, there is an excellent paper by Dave McBride, who will be our presenter today. Dave is a partner at the Wilmington law firm of Young, Conaway, Stargatt & Taylor.

And commenting on his paper will be Norman Monhait, a very experienced practitioner at the firm of Rosenthal, Monhait, Gross & Goddess. And to Dave's left is Professor Larry Hamermesh, one of the organizers of this seminar, who has done a terrific job of putting it all together and he is a professor at Widener, having practiced in this area as a partner of Morris Nichols for a number of years. Dave.

MR. McBRIDE: Thank you. I would like to start off to explain to you how I became the moderator of this program, because I think it offers some insight into the structure.

Hank Gallagher called me up and he said that a distinguished faculty was being put together for the program, and they needed some balance on the faculty. And I said, "Well, what do you mean balance?" He said, "Well, let me ask you a few questions." He says, "What does the word *Unocal* mean to you?" And I said, "A contributor to President Bush's campaign," and then he said, "That's good." And then he said, "How about *Revlon*?" And I said, "Perfume." And "*Blasius*," and I said, "Second baseman for the Texas Rangers." He said, "You are perfect."

And I said, "Hank, how can I be perfect if those are all important cases and I don't know anything about them?"

He said, "Well, the whole point of this program is to discuss whether the Delaware corporate law has become too complex and conceptual and we are going to use you as sort of the rat in the maze. We are going to see if you can navigate your way through the maze."

So that's why I am here. And you will get to decide for yourself whether I navigate myself through the maze or not.

The second thing is in talking about the efficacy of the rules that we have developed in the corporate law, there is a little story that to my mind, and maybe a simple minded way, exemplifies what I think is a potential problem. I don't think it has actually occurred, but were it ever to occur I think it would be a serious problem, and that is a lot of times when you are before a board and they are considering a business transaction, and the issue before the board is clearly a business decision, I can't tell you how many times I have gotten the question from the board or directors, is this something we can do under Delaware law.

And I have developed a stock answer, and that is that if this decision makes business sense to you, we can explain it to the court and you will not be held liable for it.

And if ever our law got to the point where you couldn't say that to a director, where you had to say, well, you know, that does make sense as a business decision, and I really believe that that is what you think is in the best interests of the corporation, and I think you may well be right, but, guess what, there is a doctrine in Delaware law that says you can't do it, then

I think we would be in some trouble, and to me that's sort of the practical, simple-minded concern I have about the law in this area.

Certainly, there are things that boards of directors should not be able to do, even when they think that they are acting for what is in the corporation's best interest because they are infringing the rights of shareholders in some respect. But when it comes to making business decisions our law ought not get to the point where business decisions that make sense can't be made because directors fear that there is some Delaware case out there that will hold them liable for having made that decision.

So with that simple-minded preface, let me turn to *Blasius*. *Blasius* is an intriguing doctrine. It basically, as I am sure almost all of you, if not all of you know, stands for the proposition that the boards of directors of Delaware corporations may not take action for the sole or primary purpose, as originally articulated, thwarting a shareholder vote, as subsequently described by the Delaware Supreme Court impeding or interfering with the shareholder vote, unless there is a compelling justification for that action.

Now, that doesn't sound like too controversial a proposition, and I think that it really ought not be too controversial a proposition. That controversy comes in trying to define how this doctrine operates and where the lines should be drawn. Or, and another point we will get to, whether there should be a separate *Blasius* doctrine, separate from *Unocal*.

So what are the difficulties with this doctrine? Well, the first difficulty is that the first part of the test requires the court to determine the apparently subjective motivation of directors, and that will occur in a context where you will have defendants determine to deny what is seemingly self-evident, aided by attorneys who are expert at making the simple complicated.

The next problem that you have is that the doctrine draws a distinction between justification and purpose. And that may not always be so clear as to what is the purpose and what is the justification, and how do you tell the difference between the two.

But that's only the first difficulty in applying the doctrine. The next, and I think the one that's most troubling, is what is the definition of conduct that thwarts a shareholder vote or interferes with or impedes a shareholder vote.

And I have said in my paper that that definition has all the precision of the definition of pornography, at least the definition I have always understood, which is I know it when I see it even if you don't. And while the cases have developed some analysis as to what that shorthand phrase means, it is an illusive concept and it is not one that can be easily and explicitly defined.

If that's difficult to define, then you turn to the question of, what is a compelling justification, and in that case no one has ever seen one, because there is no case that, having concluded that the directors have acted for the

purpose of thwarting a shareholder vote, for the sole or primary purpose of thwarting a shareholder vote, there is no case that has ever found justification that would serve to justify that conduct.

Former Chancellor Allen, who created this doctrine in a couple of opinions, I will say, discussed what might possibly serve as a justification, and, in fact, I had a case that I argued before former Chancellor Allen and one of my favorite anecdotes, and I am old enough now where I like to tell these things so I will take your time with one, we had a situation where I represented a management group that controlled about forty-three percent of the stock of the company, and they had made a bid to buy the company, and a third-party bidder came along and outbid the management group, but because the management group had forty-three percent they were only prepared to go forward if the management group would sell their shares, and, of course, my clients were buyers but not sellers at any price, and so the special committee came up with the intriguing idea of issuing an option to the what we considered hostile bidder, to give the hostile bidder an option to acquire enough shares to dilute my group down so that they could be frozen out if the other shareholders decided they liked the hostile bid.

Fortunately, the special committee, after having come up with that idea, didn't implement it because they took it back to the entire board and said, we think this is what the board ought to do, and my clients, being a majority of the board, voted it down.

So the shareholder group brought an action—I think it was Norm or his office—to enjoin our refusal to approve an option that would dilute ourselves, and in the argument before Chancellor Allen I made a sweeping and impassioned argument that it was unimaginable, just unimaginable that there could ever be a circumstance where directors would have the duty of diluting themselves, and Chancellor Allen looked at me and he said, "Well, Mr. McBride, maybe I can expand your imagination."

I looked over at my client and saw my feet shrinking. Fortunately, he did not expand my imagination at the preliminary injunction stage, but later on at a motion to dismiss he did.

But that circumstance, a circumstance like that, was one of the circumstances that Chancellor Allen had described in an opinion as a possible compelling justification for conduct that would thwart a shareholder vote, in that case the vote of my forty-three percent group.

I went through the *Blasius* cases with the idea of trying to pull out some common themes to those cases and then also addressing the question that I think Vice Chancellor Strine posed in the *Chesapeake* case and that was whether or not there is any reason to have a *Blasius* doctrine or whether we should just fold it into a *Unocal* analysis.

But let me tell you what I came away with in reviewing the cases in terms of common themes of the cases.

First of all, what conduct constitutes an interference with shareholder voting rights that triggers this doctrine?

Well, it seems that the cases look at essentially three different factors, and the third one I am not sure is a logical factor to consider in this regard, but I think it is a practical one.

One is the imminence of shareholder action that is being in some way interfered with. Now, is the shareholder action about to occur. The recent case involving state of *Wisconsin Board of Investment v. Peerless*, dealing with the adjournment of a meeting when a board-recommended stock option plan was about to be voted down, is an example of a situation where there was imminent stockholder action, voting down the stock option plan, that was frustrated by the adjournment of the meeting.

There are cases dealing with the postponement of meetings, typically *Aprahamian* was the one where the meeting was postponed on the eve of the meeting itself when the board got wind of the fact that it was about to lose the election in a controlled context situation. There was a hostile bidder I believe in that case.

Most of the other cases don't involve the same degree of imminent stockholder action, although there is typically some proposed stockholder action at issue, which is why the board is acting. The degree of interference, though, may be greater.

For example, in *Blasius* itself there was a consent solicitation going on. There was no suggestion in the opinion that that consent solicitation was necessarily going—was going to be imminently successful. The party soliciting consents had nine percent of the vote and I don't think there was any, I don't recall any discussion in the opinion, at least, as to how likely it was or not that that consent solicitation would succeed.

But the action that the board took in that case, basically, expanding the staggered board and filling the vacancies so that the consent solicitation couldn't fill the vacancies, effectively precluded the ability of the party of the shareholders in that consent solicitation to elect a majority of the board. So the preclusive effect there was at least for purposes of that election cycle for a year going to be complete.

Chesapeake, the *Chesapeake* decision was another example of action that was very nearly preclusive. In that case the corporation had a staggered board, but some corporate lawyer apparently didn't do it right and put it in the bylaws instead of in the corporate charter, and that created the possibility of amending the bylaws to eliminate the staggered board and then electing an entirely new board.

When the board realized its governance error, it attempted to correct it by amending the bylaws, and putting the super majority vote in place to prevent the bylaws from being amended. Originally I think the vote was two-thirds and then it was dropped to sixty percent, either on the eve of trial

or during trial. I am not sure which. And my recollection is the directors and officers of the company had enough stock so that if you had a ninety percent shareholder vote there would be no way you could amend the bylaws.

That was pretty preclusive action, and I don't know, I don't remember whether in the *Chesapeake* decision there was any discussion as to the likelihood or not of the shareholders actually being able to amend the bylaws and eliminate the staggered board. But the preclusive effect of that action was pretty substantial.

So the third factor that I think ends up getting considered in a way in determining whether the conduct is the type of conduct that thwarts shareholder action is really the credibility of the other purposes being offered by the directors with respect to the action at issue.

Now, when the action at issue is a business transaction, for instance, a share repurchase or a share sale, and there is an arguable business purpose for the transaction, the defendants have had a lot more success in convincing the court that the primary purpose, or sole or primary purpose of what is being done is not to thwart shareholder action.

On the other hand, when the action at issue primarily deals with the management, what I will call the management of the electoral process itself, or a change in the electoral process, not an independent business decision, and where the effect of that action is clearly to thwart shareholder action in some fashion, the defendants have been much less successful in convincing the court that their purpose is not the obvious effect of what they have done.

There is no business purpose they could typically offer for what they have done, although they may ultimately offer up a business justification. And by that I mean we are trying to defeat, we are trying to thwart the shareholders because they are about to make a stupid business decision.

That leads me to another distinction that seems pretty clear in the case between cases that involve decisions concerning the electoral process itself, not business decisions, and cases involving business decisions.

And I will come back to this at the end of my comments, but I wonder whether the *Blasius* doctrine ought to be limited to what I will call the nonbusiness cases, cases that don't involve a business transaction, however egregious or not it might be claimed that that transaction is, and be limited to cases that deal just with what I will call the management of the electoral process.

The third theme is on the question of determining motive, no *Blasius* case, at least none that I can recall or recollect, has articulated what evidentiary standard applies to determining what director motive is, and I suppose in a technical sense it may just be the usual standard in a civil case, which is by the preponderance of the evidence. But I think the fact of the cases demonstrate that the court has found that the sole or primary purpose

is to thwart a shareholder vote only where the evidence is, to borrow a word, compelling.

In most of the cases there simply is, because the conduct at issue involves the management of the electoral process, and because the impact of what the board has done is so obvious, it lacks credibility for the defendants to argue that their purpose was anything but the effect of their conduct. Where there is a business decision, obviously, the defendants have more flexibility in arguing.

And the last thing is compelling justification, and I guess there is not much more to say about that other than no one has ever seen it, but, again, when we talk about what might be done in modifying this standard, it may be that one of the things that can be done to make *Blasius* a more workable standard is to recognize that the nature of the justification sufficient to allow the board action may vary depending on how egregious the interference is.

In this class of transactions that involved thwarting the shareholder vote or interfering or impeding with the shareholder vote there still is a range of actions, some which are more, are greater interference than others, and it may be, the court has not articulated this doctrine, but it may be that the court could appropriately consider the degree of interference in evaluating what would constitute a compelling justification.

With that, let me turn to the last question that the paper addresses which is whether *Blasius* ought to be abolished and we just use the *Unocal* standard.

And while I come to the conclusion that it ought not to be, I want to start by saying that I am a firm believer that our doctrinal law could use some, what to me is simplification, that we have created such a plethora of rules that I fear that those rules can be kind of straight jackets.

I think part of the problem, I will say parenthetically on that, is a tendency—I think this comes more from the corporate transactional lawyers than it does from us good-hearted litigators—to want to turn every fact pattern into a rule, because they want rules that will say, well, I fit in this fact pattern, that's the rule for this fact pattern and, therefore, I can do this.

And to a certain extent the court has attempted, I think, to accommodate that concern by trying to articulate what to me are often times just largely factual issues into legal issues that can be applied with sort of certainty.

Anyway, why do I think that *Blasius* should have survived? Well, basically for two reasons.

One is that *Unocal* only applies, at least as I understand the doctrine, to defensive actions, and it is possible, unless we are going to make the *Blasius* test synonymous with a defensive action, it is possible that the board can take action to interfere with the shareholder franchise in a situation that

does not involve a control contest or even control the board or election of the board.

For example, in the *Peerless* case there were the adjournment of the stockholder meeting at issue was a vote on the stock option plan. Control of the corporation wasn't implicated by that transaction at all.

It seems to me that the doctrine behind *Blasius*, the desire to protect the shareholder franchise from this kind of interference, should apply in that circumstance regardless of whether or not there is a change of control at issue.

The second reason I think that *Blasius* should survive *Unocal* goes back to the rationale that Chancellor Allen gave in the original *Blasius* decision for creating it.

He noted that the decision before him was not really a business decision. In *Blasius* the board decided to expand its number and fill those vacancies so the hostile stockholder couldn't get enough votes to do that itself.

That was not a business decision. It didn't involve a business transaction. It involved a question of who should be the directors of the corporation and how should they be elected. But it didn't involve a business decision.

And he said the business judgment rule doesn't really have any meaningful application here because this isn't a business decision. And I think that's true of a lot of the circumstances where *Blasius* applies, and where *Schnell* applied before *Blasius*.

These are, when the board takes action that affects the electoral process, that's not really a business decision, and it seems to me in evaluating whether that action is equitable under *Schnell* or undertaken for a proper purpose, or whether it passes muster under *Blasius*, if *Blasius* doesn't apply, it doesn't seem to me the default ought to be business judgment, although in the *Peerless* case the Chancellor said it would be and he said that if *Blasius* doesn't apply, the business judgment rule would apply.

And I think that may be the sort of conventional wisdom now, although I am not sure that any court has really dilated on that definitively.

But those are my two reasons for believing that *Blasius* should survive independent of *Unocal*. But I qualify that with three things.

One is that I think it would be reasonable to limit *Blasius* to nonbusiness decisions and use *Unocal* in the context of business transactions, and that we perhaps need some greater doctrinal flexibility in *Blasius* to allow the court to balance the degree of interference against the justification necessary to sustain the interference. Because as the rule is articulated right now, once the court determines there is interference, as I say, there has never been a compelling justification that has served the purpose.

And with that, I have sort of presented my run through the maze of *Blasius* and probably demonstrated why Hank asked me to participate on the panel.

PROFESSOR HAMERMESH: Well, let me see if I can show you where the cheese is. Right back there.

In the paper they presented this morning the Chancellors argued that part of the doctrinal pruning that needs to get done or could possibly be done is eliminating *Blasius* as a separate legal test, and at the risk of explaining why they said that and then having them correct me and make it more accurate, my understanding of their point is that *Blasius* itself, and a lot of the cases that address that doctrine, arise in the context where directors are doing something that is squarely within the purview of *Unocal* anyway. They are doing something that tends to protect their position as directors. They are doing something defensive.

And as *Unocal* has developed, particularly with its nuanced treatment in *Unitrin*, using the concept of preclusive or coercive, the term, even the terminology in *Unocal* analysis and *Unitrin* analysis starts to blend into what *Blasius* does anyhow.

Blasius and *Unocal/Unitrin* now both ask whether or not what the directors have done amounts to an interference that is so disproportional that the court ought to strike it down in the absence of some serious, compelling justification. So that kind of balancing analysis that *Blasius* calls for is going to get evoked anyhow if *Unocal* is applied in the defensive context.

If, as David says, all we were concerned about is things directors do in the face of a contest or a threat to their control, then maybe *Blasius* wouldn't need to stand separately. I know former Chancellor Allen has a little note of dissent to that, but maybe we can come back to that.

My interest at this point is the extent to which *Blasius* does or ought to exist independent of defensive conduct, and to me that question is what is squarely posed in this relatively recent *Peerless* case.

We all understand the rationale for why *Unocal* says courts ought to look more closely at what directors do in the face of a threat to their control, because psychologically or on self interest they are operating in a circle-the-wagons mentality and we don't quite trust them the way we would trust directors in ordinary business decisions.

Fine. That may justify heightened scrutiny in the context of a case like *Blasius* where there is a threat to the directors' control.

But in the absence of that threat to control, which is what you had in *Peerless*, there is a very difficult question of why the courts should get involved at all in anything other than the utmost and most lenient kind of deference to what directors do when they run a shareholder meeting.

I am not saying I disagree with *Peerless*, but I think we have to ask ourselves what interest is supposed to be protected that should require the