

COMMENT

MM COMPANIES, INC. v. LIQUID AUDIO INC.: DETERMINATION OF THE REVIEW STANDARD WHEN DIRECTORS' DEFENSIVE MEASURE IMPEDES SHAREHOLDERS' RIGHT TO VOTE

ABSTRACT

In Blasius Industries, Inc. v. Atlas Corp., the Delaware Court of Chancery enumerated the principle that a board of directors must demonstrate a compelling justification when the primary purpose of the board's actions was designed to interfere with shareholders' voting rights. In Unocal Corp. v. Mesa Petroleum Co., the Supreme Court of Delaware enumerated a two-prong test that before the business judgment rule is applied to a board's adoption of a defensive measure, the burden will lie with the board to prove that reasonable grounds for believing a danger to corporate policy and effectiveness existed and that the defensive measure adopted was reasonable in relation to the threat posed. This comment will address the question of how to apply the standards from Blasius and Unocal when a board adopts a defensive measure in response to a threat of control where the board adopted the defensive measure for the reason of impeding the shareholders' right to vote on issues of corporate governance. In particular, this comment will evaluate the Supreme Court of Delaware's recent opinion in MM Companies, Inc. v. Liquid Audio, Inc., where that court explained that in the context of a board's adoption of antitakeover defenses to impede the shareholders' right to vote for directors, the board has the burden to demonstrate a compelling justification for taking such an action before the defensive measure could be analyzed as reasonably proportionate.

I. INTRODUCTION

Under the principles set forth in *Blasius Industries, Inc., v. Atlas Corp.*,¹ a board of directors must demonstrate a compelling justification when the board's primary purpose in taking action was to impede the shareholders' right to vote effectively.² Additionally, under *Unocal Corp.*

¹564 A.2d 651 (Del. Ch. 1988).

²*Id.* at 661 (explaining that board actions designed to interfere with shareholders' voting rights are not "per se" invalid, but instead require close judicial scrutiny in order to preserve corporate democracy).

v. *Mesa Petroleum Co.*,³ when a board adopts a defensive measure in response to a threat to corporate policy and effectiveness touching upon an issue of control, the board must show that its defensive measure was reasonably proportionate to the pending threat.⁴ The question that arises from these review standards is how to apply both standards when a board implements a defensive measure in response to a threat of control where the board's primary purpose in adopting that measure is to impede the shareholders' right to vote on issues of corporate governance.

As it is unclear how to handle this situation, the courts must decide how to implement the two existing standards of review when a factual context calls for the application of both.⁵ One approach is to require a compelling justification from the board only when the defensive action has the "substantial effect" of interfering with the shareholders' right to vote⁶ and, if not, proceed with the proportionately reasonable standard.⁷ Another approach is to require a showing of compelling justification as a condition precedent to the defensive measure being judicially analyzed as proportionately reasonable, when the defensive measure's primary purpose was to impede the shareholders' sacred right to vote.⁸

In *MM Cos. (MM) v. Liquid Audio, Inc. (Liquid Audio)*,⁹ the Supreme Court of Delaware adopted the latter approach, thereby requiring a board to show a compelling justification for its defensive action aimed at impeding the shareholders' right to vote for directors before considering whether the response was proportionate or reasonable.¹⁰ This comment will discuss relevant defense measures adopted by directors in response to the threat of a hostile takeover, as well as the need for careful judicial

³493 A.2d 946 (Del. 1985).

⁴*Id.* at 954-55 (explaining that directors must show they had reasonable grounds for believing that a threat to control existed and must proffer evidence establishing their response as proportionate to the danger posed).

⁵William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1316 (2001).

⁶Bradley R. Aronstam, *The Interplay of Blasius and Unocal—A Compelling Problem Justifying the Call for Substantial Change*, 81 OR. L. REV. 429, 432 (2002) (proposing that the "substantial effects" test should be used in deciding whether to apply the compelling justification standard).

⁷*See Unocal*, 493 A.2d at 955.

⁸*See generally* *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003) (indicating that the compelling justification standard is applied in the limited context where the primary purpose of the board's adoption of a defensive measure was to interfere with the shareholders' right to vote).

⁹*Id.*

¹⁰*See id.* at 1132. *See also* *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659-60 (Del. 1988) (reasoning that shareholders' right to vote for directors is essential to ensure the proper allocation of power in corporate governance).

examination of these actions considering the inherent conflict of interest. Additionally, this comment will evaluate the effect of *MM Cos. v. Liquid Audio, Inc.* on both the directors of a corporation and its shareholders.

II. BACKGROUND

A. *The Emergence of Hostile Takeovers in Corporate America*

The term "takeover" generally refers to an attempt by a bidder to gain control of a target company through the purchase of a controlling amount of outstanding shares of stock.¹¹ Specifically, a "hostile takeover" represents a bidder who acts without the incumbent board of director's approval and initiates an offer "directly to target shareholders."¹² If the bidder has successfully acquired a majority block of stock, it can exercise its newly-acquired control by electing its own representatives to the board of directors of the target corporation.¹³ Moreover, as soon as the bidder's representatives comprise a majority voice of the target's board, the raider has the ability to effectuate a merger.¹⁴

Since the 1980s, America has witnessed an astounding increase in the number of corporate mergers and acquisitions.¹⁵ In particular, the 1980's acquisition activity was largely predominated by hostile takeovers.¹⁶ During this time, the widespread availability of credit and capital greatly contributed to the hostile takeover trend sweeping the country.¹⁷ It was not until the October 1987 stock market crash and the demise of the junk-bond market that the number of hostile takeovers started to decline.¹⁸

¹¹1 MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS & FREEZEOUTS § 1.01[2], at 1-10.1 (2003).

¹²*Id.*

¹³*See id.* § 1.06[4], at 1-41 (explaining that "[a] raider may accumulate a block of the target's stock through private or open market purchases").

¹⁴*Id.* § 1.06[3], at 1-39 to 1-40 (identifying the "multistep transaction" as the preferred method for hostile takeovers as it deters competitive bidding).

¹⁵*See* Aronstam, *supra* note 6, at 434; Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 873 (2002).

¹⁶*See* Laurence Zuckerman, *Shades of the Go-Go 80's: Takeovers in a Comeback*, N.Y. TIMES, Nov. 3, 1994, at A1, D22 (demonstrating that hostile takeovers accounted for approximately twenty-five percent of the acquisition practice during the 1980s).

¹⁷1 ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSE § 1.01, at 1-3 (6th ed. Supp. 2002).

¹⁸*See id.* *See also* Kahan & Rock, *supra* note 15, at 879 (explaining the rationales for the decline in hostile takeovers).

By the mid-1990s, however, hostile takeovers began to make a comeback and have since remained, thereby serving as a viable option to anyone wishing to acquire a business.¹⁹ In light of today's economic conditions which have corporations trading at prices far below days past, large-scale hostile takeovers continue to be a serious threat to incumbent directors sitting on boards targeted for acquisition.²⁰

B. Popular Defensive Responses by Targeted Boards

In response to the threat of hostile takeovers, incumbent directors sitting on targeted boards have developed some tactical strategies to discourage eager bidders. These strategies will be discussed below.

1. The Staggered Board

A substantial number of public companies have recently implemented staggered boards as a powerful antitakeover defense.²¹ When a corporation implements this strategy, its board of directors is divided into classes, with each class' term of office expiring in a different year than all the others.²² Frequently, a classified board has three classes with directors' terms in class one expiring in year one, directors' terms in class two expiring in year two, and directors' terms in class three expiring in year three.²³ Staggered boards are different from boards of directors who only serve a one year term, which is the standard corporate board in Delaware.²⁴

¹⁹See Kahan & Rock, *supra* note 15, at 879 (attributing the hostile activity of the 1990s to the heightened economy during that period).

²⁰See Aronstam, *supra* note 6, at 434-35. *But cf.* LIPTON & STEINBERGER, *supra* note 11, § 1.01[1], at 1-9 (stating that although the largest mergers in history occurred in the last few years, friendly deals have been more popular than hostile takeovers).

²¹Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 889-90 (2002) (advocating the effectiveness of staggered boards as defense measures against hostile takeovers considering the significant obstacles they create for the raider).

²²See Aronstam, *supra* note 6, at 436. *See also* DEL. CODE ANN. tit. 8, § 141(d) (2003) (stating that Delaware limits the number of classes a board can have to three).

²³Richard H. Koppes et al., *Corporate Governance Out of Focus: The Debate Over Classified Boards*, 54 BUS. LAW. 1023, 1026-27 (1999).

²⁴See 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 4.6, at 4-16 (3d ed. Supp. 2003) (stating that "the general rule is that the term of a director is one year unless the board is classified by having staggered terms pursuant to Section 141(d) of the General Corporation Law"). *See also* DEL. CODE ANN. tit. 8, § 141(d) (2003) (noting that the directors of any corporation may authorize to stagger its board's terms of office but that a director will serve for only one year if the corporation has not elected to change that default rule).

The difference between a standard corporate board and a staggered board is significant. From the bidder's perspective, it would much rather acquire a company with a standard corporate board because it knows, after gaining control of the company, that it can elect its representatives to the board of directors at the next annual meeting.²⁵ On the other hand, a staggered board ensures that any unwelcome bidders launching a proxy contest will at least have to wait two years until they could gain partial control of the targeted board, and wait at least three years until the unwelcome bidder could exercise complete control over that board.²⁶

The substantial delay in gaining control of a targeted staggered board is not the only reason it serves to impede acquisition efforts.²⁷ In addition, implementation of a staggered board means that the bidder will have to be victorious in two separate proxy contests, each a year apart, as opposed to being successful in only one election where it could acquire immediate control.²⁸ The combination of the substantial delay and the need to win two successive proxy contests creates a powerful deterrent that works effectively against hostile bidders.²⁹

2. Shareholder Rights Plans

Otherwise known as the poison pill, shareholder rights plans are another effective strategy utilized in thwarting hostile takeovers.³⁰ Although the poison pill comes in many different forms, the basic premise is that "upon the occurrence of a given triggering event," shareholder rights

²⁵See BALOTTI & FINKLESTEIN, *supra* note 24, § 4.6, at 4-17. See also *id.* § 4.4, at 4-12 (providing that the target's articles of incorporation must eliminate the ability to act without written consent, or, the raider may remove a director without cause before the next annual meeting). But see DEL. CODE ANN. tit. 8, § 141(k)(1) (2003) (mandating that classified board members can only be removed with cause unless there is a provision authorizing removal without cause).

²⁶See BALOTTI & FINKLESTEIN, *supra* note 24, § 4.6, at 4-17 (adding that cumulative voting may inhibit acquiring control for three years). See also Bebchuk et al., *supra* note 21, at 890 (commenting on the significant delay caused by a staggered board, the costs of delay, and the effect of thwarting hostile bidders).

²⁷See Koppes et al., *supra* note 23, at 1030 (stating that staggered boards discourage potential raiders by making acquisition by share accumulation so expensive).

²⁸See *id.* See also Bebchuk et al., *supra* note 21, at 890 (noting that "a bidder must win two elections" in order to gain control of the target corporation).

²⁹See Bebchuk et al., *supra* note 21, at 890 (arguing that a staggered board is effective by noting that not a single target having such a defense was acquired by a bidder through a proxy contest from 1996 through 2000).

³⁰See FLEISCHER, JR. & SUSSMAN, *supra* note 17, § 5.01[A], at 5-5.

become exercisable to all shareholders except the shareholder seeking to gain control of the target corporation.³¹

A triggering event, in the eyes of an incumbent board, usually refers to a bidder's unauthorized purchase of a designated amount of stock.³² This designated amount is typically a percentage determined by the target corporation's board of directors. As such, the rights that become operational when the triggering event occurs allow shareholders of the target corporation to purchase either additional shares from the corporation, or shares held by the bidder at a significantly reduced price.³³ Many shareholder rights plans also allow shareholders to sell their shares back to the target corporation at a price much higher than they could obtain elsewhere.³⁴

The effect of the poison pill is that the bidder's voting power and substantial investment is seriously diluted.³⁵ Although the acquiror could choose to suffer the economic loss and reduction in voting power and continue to acquire the target corporation, that option usually proves itself to be too overwhelmingly expensive to remain a serious threat.³⁶ As such, the probable end result of triggering the poison pill is that the bidder will be forced to bring a proxy fight to gain control of the target corporation.³⁷

³¹See Aronstam, *supra* note 6, at 435. Cf. Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511 (1997) (examining an incumbent board's ability to continuously maintain a poison pill, or implement a pill redeemable only by continuing directors).

³²See Bebchuk et al., *supra* note 21, at 904 (stating that most companies "trigger" the pill when an acquirer buys more than ten to fifteen percent of the company's stock without the current board's approval).

³³See FLEISCHER, JR. & SUSSMAN, *supra* note 17, § 5.01[B][1], at 5-7. See also *id.* § 5.04[C][1], at 5-45 (describing the "stock purchase pill" as the most common variety of pill in use today).

³⁴See *id.* § 5.04[C][2], at 5-46 to 5-47 (explaining that the "put pill" has been less effective in deterring hostile takeovers partially because it establishes a minimum value for the target's stock).

³⁵See FLEISCHER, JR. & SUSSMAN, *supra* note 17, § 5.01[B][1], at 5-7 to 5-9; Bebchuk et al., *supra* note 21, at 904..

³⁶See Bebchuk et al., *supra* note 21, at 904-05 (stating the theory that although it is feasible for a hostile bidder to suffer through voting dilution and continue the takeover, no bidder has ever done so in the authors' fifteen-year experience). See also Aronstam, *supra* note 6, at 435 (stating that the acquisition costs in the presence of a poison pill is so prohibitively expensive).

³⁷See FLEISCHER, JR. & SUSSMAN, *supra* note 17, § 5.01[B][1], at 5-21 to 5-23.

3. Combination Punch: The Power of Implementing Staggered Boards with Shareholder Rights Plans

Before the invention of the poison pill, a staggered board was considered to be a rather weak defensive response to a possible hostile takeover.³⁸ Standing alone, the staggered board defense would make the bidder wait at least two years before he could gain control of the company, but it would not deny the inevitability of the bidder actually gaining control at the end of the delay.³⁹ Therefore, although the bidder may have been delayed in exercising his voting power,⁴⁰ the problem of the bidder purchasing a controlling block of stock and using his voting power to determine the outcome of the elections still existed.⁴¹

The implementation of a poison pill and a staggered board together, however, has produced several desirable effects. One desired effect is that the poison pill gives the target corporation and its shareholders the opportunity to dilute the bidder's voting power, thereby diluting his potential control capability.⁴² To counteract this problem, the bidder is then forced to keep buying additional shares to retain his voting power, albeit at a much higher price than the target shareholders.⁴³ Should the bidder choose to make this substantial investment, adding an effective staggered board ensures that the bidder must still win the next two elections to gain control of the company and, at a minimum, will have to wait at least two years until they can recover any money spent on the acquisition.⁴⁴

³⁸See *Bebchuk et al.*, *supra* note 21, at 903; *Koppes et al.*, *supra* note 23, at 1031.

³⁹See *Bebchuk et al.*, *supra* note 21, at 903 (stating the theory that the bidder would be able to overcome the "two-election problem" without the defense of the poison pill).

⁴⁰*Id.* at 903-04 (explaining that if a bidder is successful in purchasing a controlling block of stock, the effectiveness of the delay tactic is further undermined as incumbent directors sitting on staggered boards usually resign before the two year period is over).

⁴¹*Id.* at 903.

⁴²See *FLEISCHER, JR. & SUSSMAN*, *supra* note 17, § 5.01[B][1], at 5-7 to 5-9. See also *Kahan & Rock*, *supra* note 15, at 875 (discussing the many advantages the poison pill offers an incumbent board when compared to alternative defense strategies).

⁴³See *Aronstam*, *supra* note 6, at 435. *Contra* John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 322-23 (2000) (criticizing the judgments made about the effectiveness of poison pills or harm sustained by boards adopting them in light of the lack of the empirical evidence available).

⁴⁴See *Bebchuk et al.*, *supra* note 21, at 912-14 (explaining the essentially impenetrable barrier created by combining the poison pill with an effective staggered board considering the delay, the need to win two successive proxy contests, dilution of raider's voting power, and economic loss).

C. *The Business Judgment Rule*

When reviewing the business decisions of disinterested and independent boards of directors, it is well-settled that the courts will typically review those actions under the business judgment rule, notwithstanding that the directors have fulfilled their fiduciary duties of care and loyalty.⁴⁵ The business judgment rule presumes that directors' business decisions were made "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."⁴⁶ In order to escape the great deference afforded to the directors through the application of the business judgment rule, the complaining party must establish facts rebutting the presumption of propriety on the part of the directors.⁴⁷

Despite the business judgment rule's evidentiary burden on the moving party, the protections of the business judgment rule are not absolute, and there are some court-created exceptions to the general rule.⁴⁸ Defensive action by board members in response to a hostile contest for control is an example of such an exception.⁴⁹ The Supreme Court of Delaware has recognized the entrenchment danger in this type of scenario where incumbent directors are often tempted to protect their own interests instead of the corporation's interests.⁵⁰ As such, before the directors will be accorded business judgment deference, they must satisfy *Unocal's* two-prong test.⁵¹ First, the directors have the burden to establish that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed."⁵² Second, the directors have the burden to establish that the "defensive measure [undertaken by the board was] . . . reasonable in relation to the threat posed."⁵³

⁴⁵See BALOTTI & FINKLESTEIN, *supra* note 24, § 4.30, at 4-121; FLEISCHER, JR. & SUSSMAN, *supra* note 17, § 3.01[A], at 3-5.

⁴⁶See BALOTTI & FINKLESTEIN, *supra* note 24, § 4.30, at 4-121 (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). See also *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (explaining that courts will not second-guess the actions taken by board members by reviewing the outcome of the substantive decision but will consider the procedure in which the decision was made).

⁴⁷*Cinerama, Inc., v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995); *Aronson*, 473 A.2d at 812.

⁴⁸See *Aronstam*, *supra* note 6, at 437.

⁴⁹*Unocal*, 493 A.2d at 946.

⁵⁰*Id.* at 954 (explaining the difficulty of objective decision making and that the inherent conflict of interest in this setting warrant enhanced judicial scrutiny of boards' actions).

⁵¹*Id.* at 955.

⁵²*Id.*

⁵³*Unocal*, 493 A.2d at 955.

In addition, the Delaware Court of Chancery has recognized another exception in which defensive responses by board members are specifically designed to impede the effectiveness of the shareholder voting process.⁵⁴ This exception is that directors cannot foreclose avenues of effective shareholder action and substitute their own paternalistic views "when the question is who should comprise the board of directors."⁵⁵ Therefore, directors acting with the primary purpose of interfering with a shareholder vote must demonstrate a "compelling justification" for such action before the court will apply the business judgment rule.⁵⁶

III. ANALYSIS

In *MM Cos. v. Liquid Audio, Inc.*,⁵⁷ the Supreme Court of Delaware decided whether a corporation had the burden of demonstrating a compelling justification for implementing a defense measure designed to impede the shareholders in electing successor directors as a condition precedent to any judicial consideration of the defense measure being proportionate and reasonable to the threat posed.⁵⁸ The court held that because the primary purpose of the directors' defensive action was to interfere with or impede the effective exercise of the shareholder voting process, the board must first demonstrate a compelling justification for such action before any judicial consideration of reasonableness or proportionality.⁵⁹

A. *The Factual and Procedural History*

Defendant Liquid Audio is a publicly traded Delaware corporation with its principal place of business in California.⁶⁰ Plaintiff MM is also a publicly traded Delaware corporation but has its principal place of business in New York.⁶¹ MM, being part of a group that collectively owned over

⁵⁴See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988).

⁵⁵*Id.* at 663 (explaining the justification of the view that a board knows better than the shareholders what is in the corporation's best interests is valid in most instances but is irrelevant when considering issues of internal corporate governance because directors are really agents of the shareholders).

⁵⁶*Id.* at 662.

⁵⁷813 A.2d 1118 (Del. 2003).

⁵⁸*Id.* at 1132.

⁵⁹*Id.* (explaining that the "compelling justification" requirement under *Blasius* had to be incorporated into *Unocal's* requirements of proportionality and reasonableness).

⁶⁰*Id.* at 1122.

⁶¹*MM Cos.*, 813 A.2d at 1122.

seven percent of Liquid Audio's common stock, first indicated its desire to obtain control of Liquid Audio on October 26, 2001, when it offered to acquire the corporation for approximately \$3 per share.⁶²

Under Liquid Audio's bylaws, Liquid Audio's board is staggered and consists of three classes.⁶³ Class I has two members whose terms expired in 2003; class II has one member whose term expires in 2004; and class III had two members whose terms expired in 2002.⁶⁴

By December 2001, Liquid Audio had formal notice of MM's intention to nominate two candidates for the seats up for election on Liquid Audio's board in 2002.⁶⁵ Additionally, MM announced its intention to present a proposal at the annual meeting that would increase the size of Liquid Audio's board by four directorships.⁶⁶ In the ensuing months, MM renewed its prior offer to acquire Liquid Audio, which was rejected, and requested a list of all the shareholders of Liquid Audio, which the Liquid Audio board ignored.⁶⁷ In response, MM filed a suit seeking an order from the court of chancery compelling Liquid Audio to provide the requested information.⁶⁸

On June 10, 2002, MM filed proxy materials with the Securities and Exchange Commission and subsequently began soliciting proxies for the annual meeting scheduled for July 1, 2002.⁶⁹ MM's proxy statement contained a takeover proposal to expand the Liquid Audio board from five members to nine, and also included a recommendation of four nominees to fill those proposed positions.⁷⁰ If the proposal was adopted and MM succeeded in electing its two directors to the class III positions as well as placing its four proposed directors on the board, MM would have control of the company.⁷¹

Three days after MM sent out its proxies, Liquid Audio announced a stock-for-stock merger with Alliance Entertainment Corporation

⁶²*Id.* (explaining that Liquid Audio's board rejected the initial proposal as inadequate after Liquid Audio's investment banker analyzed the offer).

⁶³*Id.*

⁶⁴*Id.*

⁶⁵*MM Cos.*, 813 A.2d at 1123.

⁶⁶*Id.*

⁶⁷*See id.* *See also* DEL. CODE ANN. tit. 8, § 220 (2003) ("Any stockholder . . . shall, upon written demand . . . have the right . . . to inspect for any proper purpose the corporation's stock ledger.").

⁶⁸*MM Cos.*, 813 A.2d at 1123.

⁶⁹*Id.*

⁷⁰*Id.*

⁷¹*Id.*

(Alliance) and postponed its annual meeting indefinitely.⁷² Subsequently, MM amended its initial complaint and asked the court to order the annual meeting to take place, which was ordered to take place on September 26, 2002, after a hearing.⁷³

When it became clear by mid-August 2002 that MM's nominees would be elected to fill the two seats up for election, Liquid Audio's board unanimously approved the merger with Alliance⁷⁴ and announced that it had amended the company's bylaws to increase the board by two members.⁷⁵ The effect of this action reduced MM's presence on the Liquid Audio board from a possible two out of five members, to two out of seven members.⁷⁶

After MM's takeover proposal failed at the annual meeting, MM filed an amended lawsuit⁷⁷ alleging that Liquid Audio's board expansion violated the principles of *Blasius*⁷⁸ and *Unocal*.⁷⁹ At trial on October 21, 2002, the Delaware Court of Chancery denied MM relief, holding that Liquid Audio's board expansion did not violate either of the tenets set forth in *Blasius* or *Unocal*.⁸⁰ Thereafter, MM appealed to the Supreme Court of Delaware.⁸¹

B. The Supreme Court of Delaware Opinion

The Supreme Court of Delaware reversed and remanded the Delaware Court of Chancery decision, finding that the Liquid Audio's

⁷²*MM Cos.*, 813 A.2d at 1123.

⁷³*Id.* at 1124 (noting that the trial was held on July 15, 2002).

⁷⁴*Id.* Although Liquid Audio's board did not unanimously approve the merger first off, the board unanimously approved a modified merger agreement which permitted Liquid Audio to conduct a self-tender offer. *Id.* Upon consummation of the merger, Liquid Audio would own twenty-six percent and Alliance would own seventy-four percent of the combined enterprise. *Id.* Additionally, the agreement provided for a reduction of the trigger of Liquid Audio's poison pill to ten percent from fifteen percent. *Id.*

⁷⁵*Id.*

⁷⁶*MM Cos.*, 813 A.2d at 1125-26.

⁷⁷*Id.* at 1124-25 (recounting that MM filed an initial lawsuit on August 26, 2002, alleging "that the Board expansion interfered with MM's ability to solicit proxies in favor of its two nominees for election").

⁷⁸See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988) (stating that where a board's decisions interfere with effectiveness of the shareholder voting process in electing board members, a board must demonstrate a compelling justification for its action).

⁷⁹See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (explaining that defensive action taken in response to a hostile contest for control warrants heightened judicial scrutiny of a board's actions).

⁸⁰*MM Cos.*, 813 A.2d at 1121 (reasoning that the board expansion by Liquid Audio "did not impact the shareholder vote . . . in any significant way").

⁸¹*Id.*

board expansion, which was intended to impede the shareholders in electing successor directors, necessarily implicated the application of *Blasius* within *Unocal's* requirements.⁸² In coming to its conclusion, the court relied on the court of chancery's factual findings,⁸³ principles of corporate governance,⁸⁴ and corporate governance review standards including those established in *Blasius* and *Unocal*.⁸⁵

The Supreme Court of Delaware began by looking at the court of chancery's factual finding that Liquid Audio's primary purpose in expanding its board was to minimize the impact of the election of MM's two nominees to Liquid Audio's board, and thus, intended to dilute MM's voting power.⁸⁶ With the cause of Liquid Audio's board expansion in mind, the court then considered which legal analytical framework applied to the court of chancery's factual findings.⁸⁷

The court looked to the fundamental principles of corporate governance to determine which level of judicial scrutiny applies when the right to vote for successor directors has been "effectively frustrated."⁸⁸ The court found that although the fundamental tenets of Delaware law provide for a separation of control and ownership between the board and the shareholders, the stockholders' power is the right to vote on particular matters, "especially in an election of directors."⁸⁹

In addition, the court found that maintaining an appropriate balance in the allocation of power between the shareholders' right to elect directors and the board's right to manage the company hinges upon the ability of stockholders to vote for directors without interference.⁹⁰ As such, the court reiterated its mandate in *Giuricich v. Emtrol Corp.*⁹¹ where it stated: "The Courts of this State will not allow the wrongful subversion of corporate democracy by manipulation of the corporate machinery or by machinations

⁸²*Id.* at 1120-21, 1131-32.

⁸³*Id.* at 1125-26.

⁸⁴*MM Cos.*, 813 A.2d at 1126-27.

⁸⁵*Id.* at 1127-32.

⁸⁶*Id.* at 1126 (noting that Liquid Audio's board expansion reduced MM's presence and potential voting influence because instead of MM occupying two out of five seats as before the expansion, at most they would hold two out of seven seats after the expansion).

⁸⁷*Id.* at 1127.

⁸⁸*MM Cos.*, 813 A.2d at 1127-28 (noting that the most fundamental principle of corporate governance is the proper allocation of power between the corporation's stockholders and its board).

⁸⁹*Id.* at 1126.

⁹⁰*Id.* at 1127.

⁹¹449 A.2d 232 (Del. 1982).

under the cloak of Delaware law.⁹² Accordingly, the court found that heightened judicial scrutiny is required when the board's primary purpose in adopting a defensive measure is to impede the shareholders' right to vote in an election of directors.⁹³

Once the court determined that a heightened level of judicial scrutiny was needed, the court looked to corporate governance review standards to determine which review standard applies when shareholders' right to vote for directors is hindered by a board's defensive action.⁹⁴ The court found that the compelling justification standard set forth in *Blasius* applies whenever the directors act for the primary purpose of impeding the shareholders' voting of successor directors.⁹⁵ In addition, the court reasoned that the inherent conflict of interest for board members in this situation requires the application of the *Blasius* standard, either independently, or within, other review standards appropriate to the specific factual context.⁹⁶

Finally, the court looked to the standard of review pronounced in *Unocal* to determine if the Liquid Audio board had the burden of proving that its defensive action was reasonable and proportionate to the threat posed.⁹⁷ The court found, pursuant to its holding in *Gilbert v. El Paso Co.*,⁹⁸ that a reviewing court must apply the reasonableness and proportionality test whenever a defense measure is adopted in response to some threat to corporate policy which "touches upon issues of control."⁹⁹ Moreover, the court found that because Liquid Audio's board interfered with the shareholders' right to vote for successor directors in a hostile contest for control, both *Unocal* and *Blasius* were invoked.¹⁰⁰ The court explained that, within the facts of this case, it is particularly important to protect "the shareholders' franchise within *Unocal*'s requirement that any defensive measure be proportionate and 'reasonable in relation to the threat posed."¹⁰¹

⁹²*MM Cos.*, 813 A.2d at 1127 (quoting *Giwicich*, 449 A.2d at 239).

⁹³*Id.*

⁹⁴*Id.* at 1127-29 (examining the deferential business judgment rule and finding it inappropriate where a board intends to interfere with the effectiveness of a shareholder vote).

⁹⁵*Id.* at 1130 (explaining that when the "compelling justification" standard is applied, the board has the burden of proof).

⁹⁶*MM Cos.*, 813 A.2d at 1129.

⁹⁷*Id.*

⁹⁸575 A.2d 1131, 1144 (Del. 1990) (holding that the *Unocal* standard must be used in any situation where the board has reacted defensively to a threat pertaining to control).

⁹⁹*MM Cos.*, 813 A.2d at 1129-30 (citing *Gilbert*, 575 A.2d at 1144).

¹⁰⁰*Id.* at 1130, 1132.

¹⁰¹*Id.* at 1129 (quoting *Stroud v. Grace*, 606 A.2d 75, 92 n.3 (Del. 1992)).

In deciding how the two different standards of review are to apply simultaneously, the court found that the board has the burden of demonstrating the existence of a compelling justification for its action as a condition precedent to any judicial review of its action as reasonable and proportionate.¹⁰² As such, the Supreme Court of Delaware concluded that the Liquid Audio board had not met its burden of providing a compelling justification for the board expansion which impeded MM's right to vote for successor directors. Therefore, Liquid Audio's defensive measure was not reasonable and proportionate to the threat posed by MM.¹⁰³

IV. EVALUATION

In *MM Cos. v. Liquid Audio, Inc.*, the Supreme Court of Delaware rightfully determined that antitakeover defenses designed to impede the shareholders' right to vote for directors required a demonstration by the board that they had a compelling justification for taking such action before the defense measure could be analyzed as reasonably proportionate. This ruling clarified the confusion and provided a clear analytical framework for the integration of the "compelling interest" standard within the "reasonably proportionate" standard of review. In doing so, the court effectively protected the shareholder franchise and gave directors a more accurate depiction of what standard their actions will be judged.

A. *Who is Impacted by the MM Companies Decision?*

The determination that a board must first show a compelling justification for defensively interfering with a stockholder's right to vote before considering *Unocal's* reasonable grounds and response prongs is important to both shareholders and directors. The compelling justification requirement ensures shareholders that their precious right to vote for corporate management will be safeguarded against inequitable actions by corporate directors.¹⁰⁴ In addition, shareholders can now identify the parameters of protection that a reviewing court will afford them, and shareholders can now require company management to abide by those standards or otherwise seek legal redress against the company's management.

In requiring compelling justification, the court may have added a burden to board members trying to defend against a hostile takeover, but

¹⁰²*Id.* at 1132.

¹⁰³*MM Cos.*, 813 A.2d at 1132.

¹⁰⁴*Id.* at 1131-33.

this only ensures that the board members actually respect the shareholders' fundamental right to vote for directors without interference. The court recognized that some circumstances will justify the board's adoption of a defense measure which impedes the shareholders' right to vote for management, and the court decided against adopting a rule of per se invalidity.¹⁰⁵

Although company directors are not left with any guidance of what might pass muster under the compelling justification standard, directors know that the court has not ruled out that such a justification actually might exist. The court's ruling, however, does indicate to corporate directors that, in most circumstances, interfering with a shareholder's right to vote for directors in a hostile situation will not be permitted.¹⁰⁶

B. Public Policy Considerations

In *MM Cos. v. Liquid Audio, Inc.*, the Supreme Court of Delaware recognized the special importance of protecting the shareholders when a board adopts a defensive measure aimed at impeding the shareholders' power to exercise their voting rights in a contested election for directors.¹⁰⁷ This inherent conflict of interest for corporate directors requires a closer examination of corporate actions by the court.¹⁰⁸ Accordingly, the court correctly fashioned a standard of review that discourages the temptation of directors to act for their own self-interest rather than the interests of the corporation and its shareholders.

In adopting the compelling justification requirement, the court also recognized the importance of finding an appropriate balance in the allocation of power between shareholders and directors.¹⁰⁹ Although the power of managing the corporation is vested in the elected board of directors,¹¹⁰ that power is not absolute.¹¹¹ The court's decision demonstrates

¹⁰⁵*Id.* at 1128 (citing *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659-60 (Del. Ch. 1988)).

¹⁰⁶*Id.* at 1132.

¹⁰⁷*MM Cos.*, 813 A.2d at 1131.

¹⁰⁸*See supra* Part II.A.

¹⁰⁹*MM Cos.*, 813 A.2d at 1126-27.

¹¹⁰*See* DEL. CODE ANN. tit. 8, § 141(a) (2003) (imposing on the board of directors the duty to manage the business and affairs of the corporation).

¹¹¹*See supra* Part II.A.

that the effectiveness of corporate democracy depends on the shareholders' unimpeded right to vote in an election of directors.¹¹²

Without the ability of a shareholder to enforce its voting right through the protections of the court, the shareholders' voting right would be worthless. For instance, if corporate directors could impede shareholder voting in an election for those directors without consequence, then a directorship would become a dictatorship, and corporate democracy would cease to exist. In addition, withholding shareholder protection in this area would lead to understandable skepticism and doubt among shareholders, which would discourage shareholders from making the investments upon which corporate America relies.

C. *Future Role of the Courts*

As there is now a clear answer on when and how to implement the application of the compelling justification standard within the reasonably proportionate standard, courts should use this model for guidance in future decisions. Because there is still some confusion on the issue of what will qualify as a compelling justification, courts should continue to look to binding authority for guidance. Within their opinions, courts should seek out answers to this question and encourage the Supreme Court of Delaware to take up this issue on appeal to provide some definitive guidelines. Until the courts are presented with these specifications, courts should continue to protect the shareholders' voting right to the fullest extent possible.

V. CONCLUSION

In *MM Cos. v. Liquid Audio, Inc.*, the Supreme Court of Delaware held that when a board of directors employs a defense measure for the purpose of impeding shareholders' right to vote for successor directors, the directors must first show a compelling justification for their action before the defense measure will be viewed as a reasonably proportionate response to the threat. In reaching this conclusion, the court recognized the extreme importance of protecting the shareholders' right to vote for directors and, in effect, provided an effective demonstration of the correct application of the compelling justification standard within the reasonably proportionate standard of review.

While there is still some question as to what might constitute a compelling justification by the board, the courts should encourage

¹¹²See *MM Cos.*, 813 A.2d at 1127. See also Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002) (analyzing the debate over the proper purpose of the public corporation).

clarification of this issue and await further instruction from authority. In the meantime, however, courts should remember the vital importance of protecting the rights of shareholders to vote for corporate directors in order to encourage investments and preserve fundamental principles of corporate democracy.

Shaunna L. Wollpert

