NEW AND UNJUSTIFIED RESTRICTIONS ON DELAWARE DIRECTORS' AUTHORITY

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I. INTRODUCTION

In 1994, the Delaware Supreme Court enjoined and invalidated certain agreements between Paramount Communications Inc. and Viacom Inc. in connection with their merger agreement.[1] The agreements limited Paramount's ability to seek a merger partner other than Viacom. This article questions the propriety of the court's action in that case. It also considers whether, and to what extent, such contracts should be enforced in the absence of any breach of the duty of loyalty, since the board of directors has the statutory power to manage the business and affairs of the corporation.[2] It concludes that violation of the duty of care alone should not suffice to invalidate otherwise permissible action taken by the directors on behalf of the corporation, and should not limit the directors' power to contract. This is so because of (1) the importance of certainty and predictability to corporate law, (2) the uncertainty surrounding the inquiry into whether directors have complied with their duty of care, (3) the increase in cost of contracting such a limitation may cause, (4) the lack of any clear legal rationale for so limiting directorial power, and (5) the fact that courts are neither qualified nor statutorily empowered to make business decisions.

Section II of the article outlines the facts of *Paramount Communications Inc. v. QVC Network Inc.* and discusses the opinions of both the chancery court and the Delaware Supreme Court. It then attempts to discern what the Delaware Supreme Court meant when it determined that the agreements were "invalid," and on what the court based its decision.

Section III first notes that there are strong policy statements in recent Delaware case law in opposition to the court's holding. It urges that the holding is inconsistent with legislative policy, as evidenced by the recent enactment of a provision of Delaware corporate law permitting a corporation to limit or eliminate the liability of directors for violations of their duty of care.

Section III also examines various bodies of law in order to seek out a basis for the court's invalidation. It considers principles of contract law relating to enforceability, and determines that no obvious or traditional

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[1]Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994). The court of chancery's opinion in this case will also be discussed in this article. QVC Network Inc. v. Paramount Communications Inc., 635 A.2d 1245 (Del. Ch. 1993). The Delaware Supreme Court's opinion will be referred to as *Paramount* in the short form while the court of chancery's opinion will be referred to as *QVC* in the short form.

[2]DEL. CODE ANN. tit. 8, § 141(a) (1991).

reasons for voidability exist. It then turns to principles of corporate law relating to the power of the corporation. It notes that corporations have the statutory power to enter into contracts and that modern corporate statutes eviscerate the doctrine of *ultra vires*, making it an unlikely basis for voiding corporate action.

Section III then turns to the powers of corporate directors. It examines the legislative grant of power and notes that statutory law gives the board broad authority to manage the corporation. Next, it considers agency and trust law principles. It analogizes directors' power to act on behalf of shareholders to agents' power to act on behalf of principals. It compares the power of directors to manage a corporation to the power of trustees to manage a trust. No basis emerges in either agency or trust law to invalidate the actions taken by Paramount's board.

Section III also considers QVC's standing to sue. It notes that, although QVC did own a small amount of Paramount stock, it based its suit on harm suffered in its capacity as a bidder, not as a shareholder. The article concludes that QVC did not clearly have standing to bring this action under established principles of agency or contract law, or under principles permitting implied private rights of action.

Section IV discusses the extent to which directors' powers are limited by their fiduciary duties. It defines and comments on the fiduciary duties of corporate directors. It specifically considers change of control situations, in which the Delaware courts monitor directors' attention to their fiduciary obligations with heightened scrutiny. And it attempts to discern whether the law limits or eliminates directors' power to cause the corporation to enter into contracts when they act in violation of their fiduciary duties.

The article concludes that the decision in *Paramount* was erroneous when compared to established principles of law. It was also unwise, based on principles of fairness, predictability, and efficiency.

II. *PARAMOUNT COMMUNICATIONS INC. V. QVC NETWORK INC.*

In September of 1993, Paramount Communications Inc. entered into a merger agreement with Viacom Inc.[3] For several years, Paramount had been exploring the possibility of either acquiring or merging with other companies because its management believed that expansion was necessary for Paramount to remain competitive in the communications and entertainment industries.[4] Viacom had been discussed as a possible

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[3]*Paramount*, 637 A.2d at 39.
[4]*Id.* at 38.

merger partner starting in 1990, but Paramount did not vigorously pursue the transaction until mid-1993.[5] However, during the summer and early fall of 1993, Paramount's chairman and CEO, Martin Davis, met several times with Sumner Redstone, Viacom's chairman, CEO, and controlling shareholder, and they eventually agreed to merge the companies.[6] During the course of the negotiations with Viacom, Davis learned that QVC Network Inc. might also be interested in a combination with Paramount.[7] He informed Barry Diller, its chairman and CEO, that Paramount was not for sale.[8]

After protracted and vigorous negotiations, and after due diligence performed by financial advisors for both sides,[9] Paramount and Viacom signed a merger agreement on September 12, 1993.[10] Before approving the deal, the Paramount board, reviewed detailed materials provided by both Paramount's management and Lazard Freres concerning valuation and terms,[11] obtained a fairness opinion from Lazard Freres, and was advised by Paramount's counsel on how to comply with its fiduciary duties in a merger context.[12]

The agreement contemplated a merger of Paramount into Viacom in which each Paramount stockholder would receive a package of Viacom securities and cash valued at $69.14 per Paramount share.[13] The closing market price of Paramount stock on September 12, 1993, was $61,[14] so the merger agreement contemplated a premium of approximately $8 per

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[5]*Id.*

[6]*Id.*

[7]*Paramount*, 637 A.2d at 38.

[8]*Id.*

[9]Smith Barney Shearson Inc. acted as the financial advisor for Viacom, and Lazard Freres & Co. acted as the financial advisor for Paramount. *Paramount*, 637 A.2d at 39.

[10]*Id.*

[11]Compare the procedures by the board in *Paramount* with the deficient procedures undertaken by the board in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). In *Van Gorkom*, the board did not act properly under the business judgment rule when they approved the deal on short notice and with little documentation. *Id.* at 874.

[12]*QVC*, 635 A.2d at 1251.

[13]*Paramount*, 637 A.2d at 39. *See* Geraldine Fabrikant, *Martin Davis Finds His Deal*, N.Y. TIMES, Sept. 13, 1993, at D3.

> For Paramount, the sale is something of a coup. Wall Street is expected to be pleased with the price and the structure of the new company. Jessica Reif, who follows Paramount for Oppenheimer & Company, had estimated Paramount's breakup value at about $70 a share in a report last spring.

Id.

[14]Fabrikant, *supra* note 13, at D3. "The $8.2 billion sale gives Paramount shareholders a premium to the stock's current trading price of $61, a price inflated by reports of the deal throughout the past weeks." *Id.*

share.[15] In addition to specifying the terms of the merger, the agreement required the Paramount board to amend Paramount's poison pill plan to exempt the Viacom merger.[16] The agreement also contained several provisions designed to discourage or defeat potential competing offers.[17] Three provisions in particular would become the subject of litigation:

> 1. *The Termination Fee.* Paramount agreed to pay Viacom $100 million if Paramount terminated the merger agreement for a competing transaction, Paramount's shareholders failed to approve the Viacom merger, or the Paramount board recommended a competing transaction.[18]
> 2. *The Stock Option Agreement.* Paramount gave Viacom the right to purchase approximately 19.9% of Paramount's stock at $69.14 per share (the merger price) if Paramount terminated the merger agreement for a competing transaction, the Paramount shareholders failed to approve the Viacom merger, or the Paramount board recommended a competing transaction. The Stock Option Agreement contained two unusual provisions that made it more valuable to Viacom: first, Viacom could choose to pay for all but $1 per share of the Paramount stock with a subordinated note rather than with cash; and second, Viacom could elect, instead of actually purchasing the stock, to require Paramount to simply pay in cash the value of the option — the difference between the exercise price and the successful acquirer's price.[19]
> 3. *The No-Shop Provision.* Paramount's board agreed not to "solicit, encourage, discuss, negotiate, or endorse" a transaction that competed with the Viacom deal unless it was unsolicited, in writing, not subject to any material financing contingencies, and the board determined that it would breach its fiduciary duties if it failed to talk with the third party.[20]

Barely a week after the Viacom merger agreement was announced, Barry Diller sent a letter to Martin Davis proposing that QVC acquire

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[15] *Id.*

[16] *QVC*, 635 A.2d at 1251.

[17] *Paramount*, 637 A.2d at 39.

[18] *Id.*

[19] *Id.* One problem with the stock option agreement in hindsight was that it had no "cap" on its maximum value. After the bidding drove Paramount's price up by $20 per share, Paramount's cost of paying Viacom the value of the option would have been enormous.

[20] *Id.*

Paramount in spite of the defensive provisions in the merger agreement and in spite of the previous conversation between the two men.[21] QVC proposed to pay approximately $80 per share, almost $11 per share higher than the Viacom agreement promised.[22] When he discussed the QVC proposal with the Paramount board in a September 27 meeting, Davis noted that, as of the previous Friday, the market value of the QVC offer exceeded that of the Viacom offer by $18.35 per share.[23] However, he noted that a deal with QVC would trigger both the stock option and the $100 million termination fee.[24] The directors were also concerned that the no-shop provision prohibited them from talking to QVC unless they were assured that there were no major financing contingencies.[25] Accordingly, the board agreed to consider the QVC offer only if QVC could provide evidence that it had the financing to complete the deal.[26]

QVC did provide evidence of its financing, and Paramount's board authorized management to meet with QVC, but delay ensued as the parties discussed a confidentiality agreement.[27] In response to what it perceived as foot-dragging by Paramount, QVC filed a lawsuit to enjoin any contractual barriers to its offer, including the agreements between Paramount and Viacom and Paramount's poison pill plan.[28] QVC also publicly announced a tender offer for fifty-one percent of Paramount at $80 cash per share, to be followed by a merger for QVC common stock valued at approximately $80.71 per share.[29]

Viacom responded to QVC's bid by re-opening negotiations with Paramount.[30] As a result, the Viacom deal was restructured.[31] Instead of a straight merger, Viacom would tender for fifty-one percent of Paramount at $80 cash per share, followed by a second step merger for a package of Viacom securities intended to be worth approximately $80 per share.[32] Viacom agreed to give Paramount's board some additional flexibility to deal with competing offers.[33] However, the no-shop provision, the stock option agreement, and the $100 million termination

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[21] *Paramount*, 637 A.2d at 39.
[22] *Id.*
[23] *QVC*, 635 A.2d at 1253.
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *QVC*, 635 A.2d at 1253.
[28] *Id.* at 1254.
[29] *Id.*
[30] *Id.*
[31] *QVC*, 635 A.2d at 1254.
[32] *Id.*
[33] *Id.* at 1255.

fee stayed in the deal.[34] When the Paramount board approved the amended Viacom deal on October 24, its financial advisors believed that, if the Viacom deal were consummated, the securities would trade in the aftermarket at prices such that Paramount shareholders would realize a value of about $70.75 per share, compared to about $68.10 per share if the QVC deal were consummated.[35]

Paramount had retained Lazard Freres and the management consulting firm Booz-Allen & Hamilton to provide information and advice on the comparative value of combinations with QVC and Viacom.[36] Based to some extent on information provided by these advisors, Paramount's board believed that Viacom provided a better "fit" with Paramount than did QVC and that therefore, the Viacom merger would provide more long-term value for Paramount shareholders.[37] Accordingly, the board favored Viacom during the negotiations.

On November 6, Viacom unilaterally raised its price to $85, and QVC responded on November 12 by raising its price to $90.[38] Although QVC's $90 price was higher, the Paramount board determined that the QVC offer was "excessively conditional,"[39] and that the Viacom offer would provide greater value over the long term for Paramount's shareholders.[40]

QVC and a group of Paramount shareholders sued in the Delaware Chancery Court to enjoin enforcement of the termination fee, the no-shop provision, and the stock option agreement.[41] QVC also asked the court to require Paramount to remove any impediments, such as Paramount's poison pill plan, that would prevent QVC's tender offer from being "considered by Paramount shareholders on an equal footing with the Viacom transaction."[42]

Paramount was no stranger to the Delaware courts. In 1990, the Delaware Supreme Court had ruled against it in a factually similar drama in which Paramount had played the QVC role.[43] In that case, Paramount had announced a tender offer for Time Inc. after Time had entered into

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[34] *Id.*
[35] *QVC*, 635 A.2d at 1255.
[36] *Id.*
[37] *Id.* at 1255-56.
[38] *Id.* at 1256.
[39] *Paramount*, 637 A.2d at 41.
[40] *Id.*
[41] *QVC*, 635 A.2d at 1246.
[42] *Id.*
[43] Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990).

a merger agreement with Warner Communications, Inc.[44] Time responded with a series of defensive maneuvers, and Paramount sued.[45] The court sided with Time, holding that Time's board had the right to defend against unsolicited takeovers that would disrupt the board's long-range strategic plans for the company.[46] Based on that decision, Paramount's directors believed that they could legally block other offers without incurring *Revlon* auction duties,[47] because they had already determined that Viacom was a good strategic fit and that the Viacom deal was important to position Paramount "to keep pace with competitors in the rapidly evolving field of entertainment and communications."[48]

Both the chancery court and the Delaware Supreme Court noted that, unlike the Time-Warner transaction, the Paramount-Viacom transaction would result in a change of control of Paramount.[49] Viacom was controlled by its chairman, Sumner Redstone, rather than being held by "the market."[50] Over eighty-five percent of Viacom's voting stock was owned by National Amusements, Inc., and over ninety percent of

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[44]*Id.* at 1142.

[45]*Id.* When Paramount announced its tender offer, Time and Warner changed the structure of their deal from a stock-for-stock merger to a cash tender offer by Time for Warner. *Id.* at 1148. This accomplished two things: it avoided the shareholder vote required to approve a merger, and it defeated Paramount's tender offer by making the combined Time-Warner entity too large and expensive for Paramount to acquire. Both Time shareholders and Paramount sued to enjoin the defensive maneuver, but the Delaware courts found that Time was not subject to *Revlon* auction duties. *Id.* at 1151. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985); *see also infra* note 47 regarding *Revlon*. The chancery court based its decision on the fact that the Time-Warner merger did not constitute a change of control, because, both before and after the merger, control of the corporation would be held by a "fluid aggregation of unaffiliated shareholders representing a voting majority — in other words, in the market." *In re* Time Inc. Shareholder Litig., No. 10,670, 1989 WL 79880 (Del. Ch. July 14, 1989), *reprinted in* 15 DEL. J. CORP. L. 700, 737 (1989). The Delaware Supreme Court affirmed, but based its holding on the fact that, unlike Revlon, Time's corporate entity would not be broken up. *Time*, 571 A.2d at 1150. However, the supreme court agreed that the chancery court's conclusion was "correct as a matter of law." *Id.*

[46]*Time*, 571 A.2d at 1154. "Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy." *Id.*

[47]Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985). The Revlon court held that, in the course of a takeover struggle, when "it became apparent to all that the break-up of [Revlon] was inevitable . . . [t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *Id.* at 182. At that point, it was no longer appropriate for the board to adopt defensive measures designed to prevent the highest bidder from winning the auction.

[48]*Paramount*, 637 A.2d at 38.

[49]*See QVC*, 635 A.2d at 1265; *Paramount*, 637 A.2d at 43.

[50]*See supra* note 45.

National's stock was owned by Redstone.[51] Therefore, if Viacom acquired fifty-one percent of Paramount's stock, control would shift from the public shareholders to Redstone.[52] The courts reasoned that this change of control transaction provided the only opportunity for the public shareholders to realize a control premium, and thus found that the Paramount board had a duty to "take the maximum advantage of the current opportunity to realize for the stockholders the best value reasonably available."[53]

In response to the claims, Paramount argued that enhanced scrutiny under *Unocal*[54] should not apply to the board's actions because the defenses QVC complained of were not raised in response to a hostile offer; instead, Paramount entered into the agreements before any other offer took place.[55] Paramount further asserted that the board was "at all

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[51]*Paramount*, 637 A.2d at 43.

[52]*Id.*

[53]*Id.*

[54]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). The *Unocal* case is generally cited for the principle that, before the business judgment rule is applicable to defensive measures taken in response to a takeover threat, a target company's board must first prove that it undertook a reasonable investigation, that it reasonably perceived a threat, and that its response to the threat was reasonable. *See Revlon*, 506 A.2d at 181 (applying *Unocal*'s enhanced scrutiny test).

Unocal involved an attempted takeover of Unocal by T. Boone Pickens and his company, Mesa Petroleum, using a front-end tender offer for cash followed by a cash-out merger for subordinated securities. *Unocal*, 493 A.2d at 949-50. The Unocal board believed that the Mesa tender offer was coercive and not in the best interests of the company or its shareholders. *Id.* at 950-51. It crafted a defensive strategy consisting of an offer to all Unocal shareholders except Mesa. *Id.* at 951. If the front-end Mesa tender offer was successful, Unocal would purchase the remaining shareholders' stock for debt securities valued at a higher price than Mesa had offered. *Id.*

Mesa sued, claiming that the Unocal board could not exclude it from their offer, because the board owed all of Unocal's shareholders, including Mesa, the same duties. *Id.* at 953. The court cited precedents such as Cheff v. Mathes, 199 A.2d 548 (Del. 1964), a greenmail case, for the proposition that the board could indeed treat different shareholders differently, as long as the board had determined that the action was in the service of protecting the corporate enterprise from harm reasonably perceived. *Unocal*, 493 A.2d at 954. The court then held that the business judgment rule could be applicable in a takeover context. *Id.* However, takeovers presented the "omnipresent specter" of director self-dealing, so the board's actions would be subject to enhanced scrutiny before the rule would apply. *Id.* The directors would have to prove that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership," and that any defensive measures taken were "reasonable in relation to the threat posed." *Id.* at 955.

[55]*QVC*, 635 A.2d at 1264. Note that this argument is undermined by the Delaware Supreme Court's decision in Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985). *Moran*, decided soon after *Unocal*, involved a poison pill plan "adopted to ward off possible future advances," not "in reaction to a specific threat." *Id.* at 1350. The *Moran* court applied heightened scrutiny before finding that the board's actions were protected by the business

times fully informed and attentive to their duties,"[56] so *Smith v. Van Gorkom*'s[57] duty of care analysis should not limit the board's authority.[58] Finally, Paramount maintained that *Revlon* duties[59] should not apply, because this factual situation was more similar to the one in *Time*.[60]

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judgment rule. *Id.* at 1356. "[W]hen the business judgment rule applies to adoption of a defensive mechanism, the initial burden will lie with the directors." *Id.* (citing *Unocal*, 493 A.2d at 955). Therefore, there was existing authority that *Unocal* would apply to the adoption of defensive measures, regardless of the context.

[56]*QVC*, 635 A.2d at 1263.

[57]488 A.2d 858 (Del. 1985). In *Van Gorkom*, shareholders of Trans Union Corporation sued Van Gorkom (its chairman and CEO), its other directors, and Jay and Robert Pritzker, the owners of Marmon Group, Inc. *Id.* at 863-64. The case involved negotiations by Van Gorkom to sell Trans Union to Marmon.

Van Gorkom had worked for Trans Union for many years and was nearing retirement. *Id.* at 865-66. He was a substantial stockholder in the company. *Id.* at 865. Trans Union had tax benefits that it had not been able to use, and its management considered various options to try to make use of them. *Id.* at 864-65. The company's chief financial officer suggested that a sale to a company with high taxable income or a leveraged buy-out (LBO) might work. *Id.* at 865. Although Van Gorkom believed that an LBO in which management participated posed too great a risk of conflict of interest, he believed that a sale to another company might work, and he initiated negotiations with Jay Pritzker. *Id.* at 865-66.

Van Gorkom suggested a price to Pritzker based on the amount of debt Trans Union's cash flow would support. *Id.* at 866. Before he mentioned the transaction to his board of directors, the two reached an agreement in principle, and Van Gorkom even retained James Brennan as legal counsel and began to line up financing for the deal. *Id.* at 867.

When Van Gorkom did bring the deal to the board, the directors were asked to approve it with little or no documentation, and on very short notice. *Id.* at 867-68. The directors did not read the proposed merger documents, they made no independent investigation of the merits of the deal, and the company did not procure a fairness opinion. *Id.* at 868-69. Brennan did advise the board "that they might be sued if they failed to accept the offer and that a fairness opinion was not required as a matter of law." *Van Gorkom*, 488 A.2d at 868. "Based solely upon Van Gorkom's oral presentation, [statements by the chief financial officer and president/chief operating officer], Brennan's legal advice, and their knowledge of the market history of the Company's stock, the directors approved the proposed Merger Agreement." *Id.* at 869 (footnote omitted).

Although the lower court held that the directors were protected by the business judgment rule, the Delaware Supreme Court reversed. *Id.* at 870-71. The court held that the business judgment rule, "a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company," would protect a board's decision only so long as the decision was based on all relevant material information. *Id.* at 872 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)). In this case, the plaintiffs could show that the directors had so failed to inform themselves that their conduct was grossly negligent. *Id.* at 873-74. Therefore, the directors had breached their fiduciary duty of care to the company and its shareholders, and the business judgment rule did not apply. *Id.* at 874.

On remand, the case was settled. The defendants were personally liable for $23 million in damages.

[58]*QVC*, 635 A.2d at 1263.

[59]*See supra* note 47 (explaining the duties articulated in *Revlon*).

Based on *Time*, the Paramount board had the power to reject QVC's offer, even if it had a higher immediate market value than the Viacom deal, in order to carry out a strategic plan that the board reasonably believed would provide greater value over the long term.[61] Paramount argued that simply because the Viacom merger would result in a change of control in Paramount should not change this analysis to require the application of *Revlon* duties, because the Paramount shareholders would have a "significant continuing interest in the merged entity."[62] Paramount further argued that, even if the change of control meant that the Paramount shareholders were entitled to a control premium, they were in fact receiving a substantial premium in the Viacom deal.[63] Therefore, the board's actions should be judged under the *Time* rationale, and its decision to favor Viacom should be free from judicial second-guessing.[64] It is important to note that there was no claim of breach of duty of loyalty in the *Paramount* case and, in fact, the chancery court noted specifically that none had occurred.[65]

The chancery court disagreed. It found that both the *Unocal* and *Revlon* duties applied.[66] Under *Unocal*, the court would apply enhanced scrutiny to the directors' procedures and decisions to determine first, whether it was reasonable for the company to defend against a competing offer, and if so, whether the defenses actually employed were reasonable in relation to the threat posed.[67] Unless the board passed both of these tests, the business judgment rule would not apply.[68] Under *Revlon*, the court would examine the directors' conduct to determine whether it was likely to result in the best possible price for the Paramount shareholders' stock.[69]

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[60]*QVC*, 635 A.2d at 1263-64. *See supra* note 45 (setting forth the facts of *Time*).

[61]*See supra* notes 45-46 and accompanying text (setting forth the facts and holding of *Time*). Note that the *Time* court did apply a *Unocal* analysis to the actions of Time's board. *See Time*, 571 A.2d at 1142 (affirming the court's conclusion under *Unocal*).

[62]*QVC*, 635 A.2d at 1264.

[63]*Id.* at 1263, 1265.

[64]The chancery court stated that "the defendants' position is that this case is governed not by *Van Gorkom*, *Revlon*, or *Unocal*, but by *Paramount Communications, Inc. v. Time Inc.*" *QVC*, 635 A.2d at 1263.

[65]*Id.* at 1269. *See infra* text accompanying note 278 (noting that the directors had no self-interest in the transaction).

[66]*QVC*, 635 A.2d at 1265.

[67]*Id.* at 1266. *See Unocal*, 493 A.2d at 958 (applying enhanced scrutiny).

[68]*See QVC*, 635 A.2d at 1266 (stating that "the directors must satisfy the Court of the reasonableness of their actions before those actions will merit the protection of the business judgment rule").

[69]*Id.* at 1267.

The court decided that the Paramount board had unreasonably favored Viacom, and as a result, failed to investigate thoroughly the potential value of the QVC deal.[70] This failure constituted a breach of the directors' fiduciary duty of care to the shareholders.[71] The chancery court consequently enjoined the exercise of the stock option,[72] although it refused to enjoin payment of the termination fee because it found the amount to be a fair estimate of Viacom's liquidated damages if the merger was not consummated.[73]

Interestingly, the chancery court opinion does not deal directly with the no-shop provision.[74] The court's introduction to the opinion says that QVC sought

> to invalidate certain so-called "lockup" agreements, including a stock option . . . and an agreement to pay a $100 million termination or breakup fee . . . and . . . to require Paramount and its directors to remove all other impediments to QVC's tender offer so that it can be considered by Paramount shareholders on an equal footing with the Viacom transactions.[75]

This statement perhaps implies that the no-shop provision is involved in the case, but does not specify that it is. After analyzing the applicable law, the court evaluated "separately the termination fee and the stock option lockup at issue here,"[76] enjoining the exercise of the stock option, but allowing the termination fee to be paid.[77]

The Delaware Supreme Court not only affirmed the injunction, but held that the no-shop provision and stock option agreement were "invalid and unenforceable"[78] because they were "improperly designed to deter potential bidders" and did not "meet the reasonableness test to which they must be subjected."[79] Although Viacom asserted that it should be able to

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[70] *Id.* at 1269-70.

[71] *Id.* at 1270.

[72] *QVC*, 635 A.2d at 1272.

[73] *Id.* at 1271.

[74] *But see id.* at 1267-68 for a general discussion of when directors have a duty to survey the market.

[75] *Id.* at 1267.

[76] *QVC*, 635 A.2d at 1270.

[77] *Id.* at 1271-72.

[78] *Paramount*, 637 A.2d at 51.

[79] *Id.* at 50-51.

enforce its vested contract rights,[80] the court found that it was "a sophisticated party with experienced legal and financial advisors,"[81] and that Viacom knew that it was demanding unreasonable concessions in the agreements.[82] "It cannot be now heard to argue that it obtained vested contract rights by negotiating and obtaining contractual provisions from a board acting in violation of its fiduciary duties."[83]

Although the chancery court had not ruled on the no-shop provision, the supreme court said:

> We express no opinion whether certain aspects of the No-Shop Provision here could be valid in another context. Whether or not it could validly have operated here at an early stage solely to prevent Paramount from actively "shopping" the company, it could not prevent the Paramount directors from carrying out their fiduciary duties in considering unsolicited bids or in negotiating for the best value reasonably available to the stockholders.[84]

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[80] *Id.* The court was not receptive to Viacom's contract claims:

> Viacom argues that it had certain "vested" contract rights with respect to the No-Shop Provision and the Stock Option Agreement. In effect, Viacom's argument is that the Paramount directors could enter into an agreement in violation of their fiduciary duties and then render Paramount, and ultimately its stockholders, liable for failing to carry out an agreement in violation of those duties. Viacom's protestations about vested rights are without merit. This Court has found that those defensive measures were improperly designed to deter potential bidders, and that such measures do not meet the reasonableness test to which they must be subjected. They are consequently invalid and unenforceable under the facts of this case.

Id.

[81] *Id.* at 51.

[82] *Paramount*, 637 A.2d at 51. In an arm's-length bargain in which both sides had substantial bargaining power and employed financial experts and lawyers to advise them, it is difficult to understand how the court could justifiably invalidate a contract as being overreaching. This is not a case in which Viacom had some position or bargaining power to overwhelm or take advantage of a powerless or uninformed contracting partner, so the traditional unconscionability arguments are not appropriate. *See infra* notes 151-55 and accompanying text (discussing the contract principle of unconscionability and applying it to *Paramount*). And if it was not clear to the Paramount directors, after advice of counsel, that the agreements would breach their fiduciary duties, it is questionable from a policy standpoint to invalidate the contracts. *See infra* Part III.B and accompanying text (discussing and applying general contract principles).

[83] *Paramount*, 637 A.2d at 51.

[84] *Id.* at 49 n.20 (citing Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1287 (Del. 1989)).

The chancery court and the supreme court also differ slightly in their articulation of when and how the Paramount board breached its duty of care. The chancery court noted that in change of control transactions, "the directors must satisfy the Court of the reasonableness of their actions before those actions will merit the protection of the business judgment rule."[85] It continued, "Both *Revlon* and the fundamental duty of due care require that the directors establish that their decision was adequately informed . . . ."[86] But, considering the care that the board took when entering into the Viacom transaction, the chancellor concluded, "I find no basis to criticize the sufficiency of the board's information or processes up to November 12, when QVC raised its offer to $90 on the 'front end.'"[87]

After that time, however, the chancery court found that the directors did not have sufficient information to reasonably conclude either that the Viacom deal provided higher long-term value or that the QVC offer was excessively conditional.[88] Their failure to adequately inform themselves was a breach of the duty of care to the company and its shareholders.

The Delaware Supreme Court agreed that the directors had failed to inform themselves, but the opinion suggests that the directors' process became deficient at an earlier date, perhaps even at the outset. "When entering into the Original Merger Agreement, and thereafter, the Paramount Board clearly gave insufficient attention to the potential consequences of the defensive measures demanded by Viacom."[89] The court also noted that, when the original merger agreement was renegotiated in late October, "it should have been clear to the Paramount Board that the Stock Option Agreement, coupled with the Termination

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[85]*QVC*, 635 A.2d at 1266.

[86]*Id.* at 1267.

[87]*Id.* at 1269.

[88]*Id.* Even though the Paramount board had used financial experts to help it determine Paramount's value when it negotiated the merger with Viacom, it apparently should have revisited that issue. "*Barkan* teaches some of the methods by which a board can fulfill its obligation to seek the best value reasonably available to the stockholders. . . . They include conducting an auction, canvassing the market, etc." *Paramount*, 637 A.2d at 44 (citing Barkan v. Amsted Indus., 567 A.2d 1279, 1286-87 (Del. 1989)). *But see Barkan*, 567 A.2d at 1287 (noting that if "directors possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve that transaction without conducting an active survey of the market" but recognizing that canvassing the market will frequently provide more dependable information).

[89]*Paramount*, 637 A.2d at 49.

Fee and the No-Shop Clause, were impeding the realization of the best value reasonably available to the Paramount stockholders."[90]

The supreme court's opinion may support its conclusion that the contracts were unenforceable, or could be set aside in equity. The court determined that the contracts were not fair to Paramount and its shareholders because they kept the shareholders from receiving "the best value reasonably available" in return for their control of Paramount.[91] It held that the Paramount directors had violated their duty of care in not investigating QVC's offer carefully enough.[92] And it found that Viacom should have known it was overreaching, so the court's concern for fairness did not require the contracts to be enforced to protect Viacom.[93] Even if the contracts could be enjoined, however, the opinion does not clearly explain why they were "invalid." A board of directors certainly has the power and authority to cause the corporation to enter into contracts under normal circumstances. If the contracts were unfair, they could be enjoined at equity; if they were in violation of the directors' fiduciary duties, the directors could be held personally liable for any harm accruing to the corporation or its shareholders as a result of the breach. But here, the court not only enjoined the contracts, it also said that they were "invalid." What did the court mean by using that term, and why did it decide that the contracts were invalid?

There are several possible explanations. Perhaps the court meant that the directors lacked either the authority or the power to cause the corporation to enter into the contracts. Perhaps the corporation itself lacked the power to enter into the agreements. The court may have possibly believed that Viacom was not entering into the agreements in good faith, and that they were therefore invalid based on Viacom's misconduct, rather than (or in combination with) misconduct of the Paramount directors. The court, however, said only that the contracts were invalid because the directors did not have the power to enter into

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[90] *Id.* at 50.

[91] *Id.* at 49 n.20.

[92] *Id.* at 50.

[93] *Paramount*, 637 A.2d at 51. Under general principles of contract law, the court could have enforced the contracts even if they violated the Paramount directors' fiduciary duty if it had found that Viacom was unfairly deprived of its contract rights. *See* RESTATEMENT (SECOND) OF CONTRACTS § 193 cmt. a (1981) ("A promise by a fiduciary to violate his duty as a fiduciary is unenforceable on grounds of public policy, as is a promise that tends to induce such a violation. In an exceptional case, however, a court may conclude that the interests of third parties require enforcement.").

contracts that were in violation of their fiduciary duties[94] or that limited the exercise of their fiduciary duties.[95]

III. CORPORATE CONTRACTS

A. *Some Principles of Delaware Corporate Law*

1. Principles of Formality and Finality

Courts have articulated two principles of decision that militate against the *Paramount* holding. One is the principle of formality in the interpretation of Delaware's corporate statutes. To determine the validity or propriety of corporate transactions, courts are directed to look to compliance with the formal statutory authority relied upon by the parties to a transaction instead of examining the substance of the transaction.[96] The policy reason for this principle is that formality promotes certainty and efficiency by allowing corporate planners to order their conduct to comply with fixed norms. The second principle, which might be termed the principle of finality, relates to the validity of contracts. The general rule, in Delaware and elsewhere, is that the validity of a contract is determined at the time it was entered into, and depends on the situation existing at that time.[97] Again, the policy justifications for this rule are certainty and efficiency.

As discussed later in this article, corporate directors have broad authority and power to manage the business and affairs of their

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[94]*Paramount*, 637 A.2d at 51.

[95]*Id.; see also id.* at 48.

[96]*See* Uni-Marts, Inc. v. Stein, No. 14,713, 1996 Del. Ch. LEXIS 95, at *28-29 (Del. Ch. Aug. 9, 1996) (mem.).

[97]*Cf.* RESTATEMENT (SECOND) OF CONTRACTS § 208 ("If a contract or term thereof is unconscionable *at the time the contract is made* a court may refuse to enforce the contract . . . .") (emphasis added); § 201 ("Where the parties have attached different meanings to a promise . . . it is interpreted in accordance with the meaning attached by one of them . . . *at the time the agreement was made* . . . .") (emphasis added). With respect to capacity to contract, *see also* E. ALLAN FARNSWORTH, CONTRACTS (2d ed. 1990) ("With respect to immaturity, the law has tenaciously adhered to an arbitrary standard — the attainment of a prescribed age *at the time of the making of the contract* . . . .") *Id.* § 4.3 (emphasis added); ("Since it is [mental] competency *at the time the agreement was made* that is critical, it is enough if the party had a 'lucid interval' at that moment.") *Id.* § 4.6 (emphasis added) (citation omitted). With respect to legality, *see id.* ("In general, the relevant legislation is that in effect *at the time the agreement was made.* Therefore, courts have usually held that if a promise is unenforceable on grounds of public policy when made, it does not become enforceable if the legislature later changes the law . . . .") *Id.* § 5.5 (emphasis added) (citation omitted).

corporations.[98] As a technical matter, the Paramount directors had the statutory authority to make the decisions and take the actions that they did in connection with the Viacom transaction.[99] However, even though the directors had statutory power as a technical matter, the *Paramount* decision suggests that this power was vitiated by their negligence.

A more recent Delaware case, however, disapproves of the use of a directors' breach of the duty of care to invalidate a transaction otherwise valid under the Delaware statutes. In *Arnold v. Society for Savings Bancorp, Inc.*,[100] plaintiff sought to void a merger and recover damages from directors who had breached their fiduciary duty of care[101] by not making adequate disclosures in the proxy statement pursuant to which the merger was approved. The court declined to void the merger, noting that:

> [t]he corporate defendants . . . complied with all of the express statutory requirements for the merger. The merger statutes do not explicitly require the company to inform stockholders of all material facts.
>
> [Plaintiff argued that an uninformed shareholder vote did not satisfy the statutory requirement of a stockholder vote, because it constituted a breach of the directors' fiduciary duties.] The duty to act in an informed and deliberate manner when following the statutory procedure arises out of the fiduciary duties imposed upon directors by decisional law. Hence, the argument that the disclosure violation renders the statutory merger void must fail.[102]

The court also declined to assess damages against the breaching directors because the corporation had included in its certificate of incorporation an exculpation provision under section 102(b)(7) of the Delaware Code.[103] Noting that the lack of remedy was "directly attributable to the decision of the stockholders of Bancorp to enact" the

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[98]*See infra* section III.D.1, dealing with the authority of directors to act on behalf of the corporation.

[99]*E.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1991) (authority to manage corporation); § 157 (authority to issue options); § 251 (authority to enter into merger agreements).

[100]678 A.2d 533 (Del. 1996).

[101]The lower court had held there was no breach of loyalty or good faith. *Id.* at 534.

[102]*Id.* at 536-37 (footnotes and citations omitted).

[103]*See infra* text Part III.A.2.

provision, the court recognized that plaintiffs were in fact without a remedy.[104]

Delaware case law also explains the importance of formal compliance with statute in the corporate arena, and suggests that courts should refuse to entertain arguments that the substance of an action, rather than its form, should control.[105] Therefore, if a limitation is not imposed by statute, the courts should not limit directorial power. A very recent Delaware case clarifies the policy reasons for this position:

> [W]hen construing the compliance of a transaction with applicable provisions of the Delaware General Corporation Law our law does not employ a "functional equivalency" type of analysis (in which the regulation applied to one form of transaction is applied to all forms of transaction that are its functional equivalent). Instead, when construing the reach and meaning of provisions of the Delaware General Corporation Law, our law is formal. . . . Formality has significant utility for business planners and investors. While the essential fiduciary analysis component of corporation law is not formal but substantive, the utility offered by formality in the analysis of our statutes has been a central feature of Delaware corporation law.[106]

For instance, the board of directors of a Delaware corporation has the statutory power to accomplish a transaction that would have the same effect as a merger via the issuance of stock to an acquirer. The directors have the power to issue authorized but unissued stock without approval of the shareholders.[107] If Corporation A had sufficient authorized but unissued stock, its board of directors could purchase the stock or assets of Corporation B in exchange for a number of shares equal to, or in excess of, the number of Corporation A shares already outstanding, in

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[104] *Arnold*, 678 A.2d at 541.

[105] *Uni-Marts*, No. 14,713, 1996 Del. Ch. LEXIS 95, at *28.

[106] *Id.* at *28-29.

[107] *E.g.*, DEL. CODE ANN. tit. 8, § 161 (1991, provides:

> The directors may, at any time and from time to time, if all of the shares of capital stock which the corporation is authorized by its certificate of incorporation to issue have not been issued, subscribed for, or otherwise committed to be issued, issue or take subscriptions for additional shares of its capital stock up to the amount authorized in its certificate of incorporation.

Id.

effect transferring a controlling interest in Corporation A to the former owner of Corporation B's assets.

In some states, such a transaction might be considered a *de facto* merger,[108] and shareholders would be entitled to the rights accorded to shareholders in a statutory merger, such as voting and appraisal rights. However, in cases such as *Hariton v. Arco Electronics, Inc.*,[109] the Delaware Supreme Court has indicated that Delaware does not recognize the *de facto* merger doctrine, and that the court will look to the words of the statute rather than the effect of the transaction when determining what rights shareholders may have in such a transaction.[110] As long as the directors' actions are permitted under some section of the statute, the court will not intervene.[111]

In the *Paramount* case, Paramount's directors had the formal power to enter into the contracts with Viacom.[112] Therefore, *Hariton*, *Uni-Marts*, and *Arnold* do not square with *Paramount*.

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[108]*See, e.g.*, Department of Transp. v. PSC Resources, Inc., 419 A.2d 1151, 1154 n.4 (N.J. Super. Ct. App. Div. 1980) (holding that in New Jersey a *de facto* merger requires "continuity of management, personnel, physical location, assets and general business operations; continuity of shareholders since the purchasing corporation pays with its stock; seller ceases operation and dissolves; assumption of obligations necessary for the uninterrupted continuation of normal business operations"); Irving Bank Corp. v. Bank of N.Y. Co., 530 N.Y.S.2d 757, 760 (N.Y. Sup. Ct. 1988) (holding that New York recognizes the *de factor* merger doctrine in situations where the actual merger takes place soon after the initial transaction and the seller corporation quickly ceases to exist).

[109]188 A.2d 123 (Del. 1963). Arco Electronics agreed to transfer its assets to Loral Electronics in exchange for Loral stock. Arco would then distribute the stock to its shareholders and dissolve. Although Delaware law entitled Arco shareholders to a vote on the sale of assets, the structuring of the transaction as an asset sale rather than a merger meant that they were not entitled to appraisal rights. The court held that the board could structure the transaction as an asset sale to avoid appraisal rights, even though it had the same effect as a merger.

[110]*See also* Arnold v. Society for Savings Bancorp, 678 A.2d 533 (Del. 1996); Uni-Marts, Inc. v. Stein, No. 14,713, 1996 Del. Ch. LEXIS 95 (Del. Ch. Aug. 9, 1996).

[111]In *Hariton*, the Delaware Supreme Court held that a reorganization structured as a sale of assets followed by a dissolution was legal, even though it had the same effect as a merger. *Hariton*, 188 A.2d at 125. "This is so because the sale-of-assets statute and the merger statute are independent of each other. They are, so to speak, of equal dignity, and the framers of a reorganization plan may resort to either type of corporate mechanics to achieve the desired end." *Id.* In *Paramount*, not only did the board have statutory authority to issue stock options, but the chancery court noted that there was also precedent for the issuance of options as large as that granted by Paramount to Viacom. *QVC*, 635 A.2d at 1271. It cited two cases in which large options were upheld: *In re* Vitalink Communications Corp. Shareholders Litig., No. 12085 (Del. Ch. May 16, 1990); and Hecco Ventures v. Sea-Land Corp., No. 8486, 1986 WL 5840 (Del. Ch. May 19, 1986), *reprinted in* 12 DEL. J. CORP. L. 282 (1987).

[112]*Paramount*, 637 A.2d at 42.

The second principle of decision that bears on the correctness of the *Paramount* decision is finality. This principle urges that if the contract between Paramount and Viacom was valid on the date it was signed, then a court should not invalidate it later based on subsequent events. As noted above, the corporations and their boards had the statutory power to negotiate and enter into contracts. The Paramount board had the power to issue stock options, agree to termination fees, and enter into no-shop agreements; none of these acts was prohibited by statute or by case law.

The *Paramount* court did not dispute the statutory powers of directors; it proposed instead that the board did not have the power to act in violation of its fiduciary duty.[113] But even if that were so,[114] under the principle of finality, the time at which compliance with fiduciary duty should be examined is the time at which the contracts were entered into, not some later time.

At the time Paramount and Viacom entered into their merger agreement, there is no evidence that they were aware of any fiduciary impediments to their deal. Unlike the board of directors in *Smith v. Van Gorkom*,[115] the Paramount board was not passive. The Paramount directors were aware of the merger negotiations,[116] had time to consider the transaction carefully,[117] sought advice of counsel on fulfilling their fiduciary duties,[118] and retained financial experts to advise them on the value of the proposed combination with Viacom.[119] The board may have been mistaken as to the value of the Viacom merger or the need for the restrictive provisions, but it certainly considered them at the time the board caused Paramount to enter into the transaction.[120] Indeed, the

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[113] *Id.* at 49-50.

[114] *See infra* discussion Part III.A.2 (arguing that the court is incorrect to assert that directors lack the power to violate their fiduciary duties).

[115] 488 A.2d 858 (Del. 1985).

[116] *Paramount*, 637 A.2d at 39. *Cf. Van Gorkom*, 488 A.2d at 866 (noting that directors had no role in or even awareness of negotiations between Van Gorkom and Pritzker).

[117] *Paramount*, 637 A.2d at 39-41. *Cf. Van Gorkom*, 488 A.2d at 868-69 (noting that directors were required to hastily decide on approval of a transaction without access to merger documents or consideration of valuation issues).

[118] *Paramount*, 637 A.2d at 39-41. *Cf. Van Gorkom*, 488 A.2d at 880 (noting that Van Gorkom retained counsel, but as the court noted with some disapproval, his advice was both cursory and inadequate).

[119] *Paramount*, 637 A.2d at 39. *Cf. Van Gorkom*, 488 A.2d at 866 (noting that the price Van Gorkom negotiated for sale of the company was based on the debt that could be supported by its cash flow, rather than its value).

[120] *Cf.* Litwin v. Allen, 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940). In commenting on a transaction approved by the board of directors of a bank, the court reasoned:

Experience turned out to be fallacious and judgment proved to be erroneous;

chancery court found no breach of any fiduciary duty at the time the board caused Paramount to enter into the merger agreement with Viacom,[121] or even later, when it renegotiated the deal.[122] The supreme court was less specific about when the breaches of fiduciary duty took place, but did not hold that the Paramount board violated its duty when it signed the merger agreement.[123] Therefore, unless there are other grounds for declaring the contracts invalid from their inception, the court should have held them to be valid and enforceable.

This principle of finality allows contracting parties to predict with some certainty the legal consequences of their agreements. It encourages them to rely on the promises of others, and to live up to their own promises, because they can reasonably expect courts to enforce these promises. This certainty or predictability has enormous value, both to the parties themselves and to others who are affected by performance of the agreements, because it renders costly monitoring behavior and insurance unnecessary. Certainty operates not only to the benefit of corporate boards, but it also benefits shareholders and other constituents because it provides them with a basis on which to predict the consequences of a contract, and as a result, a basis on which to act themselves.

2. Exculpation Statute

If it is truly the law of Delaware that directors cannot enter into contracts that limit the exercise of their fiduciary duties, one wonders why section 102(b)(7) of Delaware's corporation law exists.[124] If

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> but that did not become apparent until some time [the following year]. In order to judge the transactions complained of, therefore, we must not only hold an inquest on the past but, what is much more difficult, we must attempt to take ourselves back to the time when the events here questioned occurred and try to put ourselves in the position of those who engaged in them.

Id. at 677.

[121] *QVC*, 635 A.2d at 1269.

[122] *Id.*

[123] *Paramount*, 637 A.2d at 49.

[124] This section permits a corporation to include in its certificate of incorporation:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) [for unlawful payment of dividends or unlawful stock purchase or redemption]; or (iv) for any transaction from which the director derived an improper personal benefit.

shareholders can agree to exculpate the directors for breaches of fiduciary duty, then the directors must have the power to breach. So why should directors not be able to enter into a contract that may limit their ability to exercise their fiduciary duties? If directors in fact fail to exercise the fiduciary duty of care, the shareholders should have an action against the directors for any damage resulting to the shareholders or the corporation, unless the shareholders have agreed *ex ante* to exculpate the directors.

B. *General Contract Principles*

What does it mean to say that a contract is "invalid"? Invalid is defined in part as "not of binding force or legal efficacy; lacking in authority or obligation."[125] The Restatement (Second) of Contracts does not use the term invalid. Contracts may be voidable or unenforceable, but there is no Restatement provision (or Delaware statute) that defines an "invalid" contract.[126] The Restatement uses the term "voidable" to refer to a contract in which a party to the contract can avoid its obligations. Neither Paramount nor Viacom attempted to avoid its contractual obligations in this case, so perhaps the Delaware court's intended meaning of invalid is more like "void," i.e., not a binding contract at all. Or perhaps the court is simply affirming the injunction, and is using invalid to mean enjoined.[127] If this is the case, however, the

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DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1994).

[125]BLACK'S LAW DICTIONARY 739 (5th ed. 1979).

[126]The Restatement deals with enforceability in the following definitional sections:

> § 1. Contract Defined. A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty.
>
> § 7. Voidable Contracts. A voidable contract is one where one or more parties have the power, by a manifestation of election to do so, to avoid the legal relations created by the contract, or by ratification of the contract to extinguish the power of avoidance.
>
> § 7 cmt. a. "Void contracts." A promise for breach of which the law neither gives a remedy nor otherwise recognizes a duty of performance by the promisor is often called a void contract. Under §1, however, such a promise is not a contract at all; it is the "promise" or "agreement" that is void of legal effect. If the term "contract" were defined to refer to the acts of the parties without regard to their legal effect, a contract could without inconsistency be referred to as "void."
>
> § 8. Unenforceable Contracts. An unenforceable contract is one for the breach of which neither the remedy of damages nor the remedy of specific performance is available, but which is recognized in some other way as creating a duty of performance, though there has been no ratification.

RESTATEMENT (SECOND) OF CONTRACTS §§ 1, 7 & cmt. a, & 8 (1981).

[127]*Cf.* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985).

word "invalid" becomes mere surplusage. Assuming that the court used the word to convey an independent meaning, what might the court have meant? What makes a contract "invalid"? There are many possibilities, but several might be relevant in this context:

1. *Lack of capacity to contract.*[128] Paramount and Viacom were both Delaware corporations. The Delaware Code specifically gives corporations the capacity to enter into contracts[129] and gives boards of directors the power to cause their corporations to act.[130]

2. *Lack of power or authority to contract.* Under Delaware law, a board of directors normally has the power and authority to cause the corporation to enter into contracts.[131] However, *Paramount* holds that because the board lacked the authority to cause Paramount to make the promises that it did (because those promises violated the directors' duty of care), it thus lacked the power to do so. The court stated, "To the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable."[132] Directors certainly do not have the *authority* to breach their fiduciary duties, but this statement proposes that directors do not have the *power* to breach their fiduciary duties. As authority for this proposition, the court cited a 1964 Delaware case, *Wilmington Trust Co. v. Coulter.*[133] The facts of that case are fairly complex, but a synopsis of them may assist an attempt to understand the *Paramount* court's conclusion.

Wilmington Trust Co. (WTC) and Guy A. Gladson were the trustees of a trust with assets that included eighty-two percent of the stock

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In *Revlon*, the Delaware Supreme Court seems to use the words "enjoined" and "invalid" almost interchangeably. The court states that it will decide "the *validity* of such defensive measures," but concludes that "the *enjoined* Revlon defensive measures were inconsistent with the directors' duties to the stockholders." *Id.* at 176 (emphasis added). The intervening text does not suggest that the court intends to refer to two different things. Similarly, later in the opinion, the court says that the "Court of Appeals for the Second Circuit *invalidated* a lock-up on fiduciary duty grounds," but then quotes a section of the opinion in which the Second Circuit states that it is deciding whether to "*enjoin*" a lock-up option. *Id.* at 183 & n.15 (citing Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264 (2d Cir. 1986)) (emphasis added).

[128]"No one can be bound by contract who has not legal capacity to incur at least voidable contractual duties." RESTATEMENT (SECOND) OF CONTRACTS § 12 (1981).

[129]DEL. CODE ANN. tit. 8, § 122(13) (1991) ("Every corporation created under this chapter shall have power to . . . [m]ake contracts . . . .").

[130]*See infra* Part III.D.1.

[131]*Id.*

[132]*Paramount*, 637 A.2d at 51.

[133]200 A.2d 441, 452-54 (Del. 1964).

of the Toledo, Peoria & Western Railroad Company (TP&W).[134] After extended negotiations with multiple bidders, and after telephone approval of the deal by Gladson, WTC signed a letter agreement on April 15, 1955 with two buyers, the Santa Fe and Pennsylvania Railroads, promising to sell them fifty-two percent of the TP&W stock at $100 per share.[135] The deal was conditioned on approval of the purchasers' boards and approval of the Interstate Commerce Commission (I.C.C.).[136] Heineman, a disappointed bidder, then contacted WTC and offered to buy all of the trust's TP&W stock at $133.33 per share, subject to shareholder and I.C.C. approval, and subject to the trustees' ability to withdraw from the earlier agreement.[137]

The trustees might have been able to withdraw from the April 15 contract without liability, since neither the required board and I.C.C. approvals nor the written consent of Gladson to the sale (required under the terms of the will that established the trust) had yet been received.[138] However, WTC did not even inform Gladson of Heineman's offer.[139] Eventually, some of the trust beneficiaries found out about the offer and pressured WTC until it agreed to withdraw from the earlier deal.[140] When Santa Fe and Pennsylvania were informed of the withdrawal, Santa Fe responded by increasing its offering price; it purchased all of the trust's TP&W stock at $135.[141] It sold half the stock to Pennsylvania, and then the two sued the trust to enforce their earlier $100 agreement.[142] The suit was settled for $500,000 in trust assets.[143] Gladson's successor, Coulter, then sued WTC to recover the trust assets, and the court found WTC liable for the full $500,000 for failing to withdraw from the earlier deal and failing to communicate the higher offer to its co-trustee.[144]

The portion of the case cited by the *Paramount* court is Justice Wolcott's denial of WTC's petition for a rehearing.[145] WTC asserted that it should not be liable for failing to withdraw from the April 15 deal, because it had no right to withdraw.[146] It reasoned that, even if some

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[134] *Id.* at 443.
[135] *Id.* at 446.
[136] *Id.*
[137] *Wilmington Trust*, 200 A.2d at 446.
[138] *Id.*
[139] *Id.*
[140] *Id.* at 447.
[141] *Wilmington Trust*, 200 A.2d at 447.
[142] *Id.*
[143] *Id.*
[144] *Id.* at 452.
[145] *Paramount*, 637 A.2d at 51.
[146] *Wilmington Trust*, 200 A.2d at 453.

conditions had not yet been satisfied, the contract "was at least a binding option to hold the offer open until Pennsylvania's Board had time to act."[147] WTC, therefore, concluded that it could have been sued if it attempted to withdraw from the April 15 agreement.[148] The court maintained, however, that even if Pennsylvania and Santa Fe had sued WTC for breach of contract, WTC would have had a valid defense in that it lacked the power to enter into an option to sell trust assets.[149] The court also noted that WTC was not empowered to sell trust property without the written consent of Gladson; since his written consent to the April 15 agreement had not yet been received, WTC would have had another defense.

The whole tenor of this portion of the opinion is that the trust was not bound to the April 15 agreement because of basic principles of trust law (WTC did not have the power to bind the trust), because of the terms of the agreement itself (conditions had not yet been satisfied), not that WTC had breached its fiduciary duties by entering into the agreement. The fiduciary duty argument enters later — if WTC did not have the power to bind the trust, then the contract was voidable, and if it was voidable, then WTC had a duty to avoid it when a better opportunity presented itself.[150] WTC thus breached its fiduciary duty by failing to withdraw from the agreement. Even if that is a correct statement of the law, the *Wilmington Trust* case is inapposite to the proposition for which the *Paramount* court cites it as authority.

Is the *Paramount* court perhaps citing this discussion for the proposition that, even if the Paramount board did not violate any duties when it caused Paramount to enter into the Viacom agreement, it had a duty to somehow avoid the Viacom deal when a better deal came along? If so, the *Wilmington Trust* rationale would require that action only if the Viacom contracts were somehow voidable or void. In *Wilmington Trust*, the agreement was void because of basic principles of trust and contract law, not because it violated fiduciary duties. In *Paramount*, the court says that the Viacom agreement violated fiduciary duties, and that somehow made it void. *Wilmington Trust* may lead us to the conclusion that if the Paramount/Viacom agreements were voidable, and if a better

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[147] *Id.*

[148] *Id.*

[149] "The general rule, however, is that a general power to sell trust assets given a trustee does not ordinarily include within it the power to grant options for the sale of trust property, absent a showing that only by the granting of an option may a sale be advantageously made." *Id.*

[150] *Id.* at 454.

deal came along, then the Paramount board would have the obligation to avoid the Viacom deal. It does not tell us, however, as the court suggests that it does, that the Paramount/Viacom agreements were in fact voidable.

Wilmington Trust might justifiably be cited in support of the conclusion that, when Paramount had the opportunity to renegotiate the Viacom deal, it should have been more forceful in negotiating away the defensive provisions so that the board could more easily entertain competing bids. The opinion can be understood to say that when a fiduciary has the opportunity to benefit the object of its fiduciary duties, it is obligated to take advantage of that opportunity. But that is not the proposition for which it is cited by the *Paramount* court.

3. *The contract is unconscionable at the time it is entered into*[151] *or is against public policy.*[152] Public policy does not disfavor the transfer of corporate control to new owners who value it more highly than the old owners, so the transfer of corporate control itself is not problematic.[153] Paramount and Viacom were both sophisticated bargaining parties, they employed expert advisors, and each had considerable bargaining power.[154] Unconscionability is not the issue here.[155] The court's complaint seems

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[151]RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981).

[152]*Id.* § 178.

[153]*See, e.g.*, Edgar v. MITE Corp., 457 U.S. 624 (1982) (declaring an Illinois law that regulated tender offers unconstitutional):

> The effects of allowing the Illinois Secretary of State to block a nationwide tender offer are substantial. Shareholders are deprived of the opportunity to sell their shares at a premium. *The reallocation of economic resources to their highest valued use, a process which can improve efficiency and competition,* is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced.

Id. at 643 (emphasis added). *See also, e.g.*, Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978).

> The market for corporate control and the threat of cash tender offers in particular are of great importance in creating incentives for management to maximize the welfare of shareholders. Theoretically, shareholders may oust poor management on their own initiative, but the costs to individual shareholders of monitoring management performance and campaigning for its defeat in shareholder elections when performance is poor are prohibitive. On the other hand, inefficient performance by management is reflected in share price thus making the corporation a likely candidate for a takeover bid. Since a successful takeover bid often results in the displacement of current management, managers have a strong incentive to operate efficiently and keep share prices high.

Id. at 9.

[154]*See supra* text accompanying note 9.

[155]The court did chastise Viacom for overreaching when it denied that Viacom had

to be that Paramount did not procure as good a bargain as it could have, not that Paramount was unable to procure a good bargain because of Viacom's leverage or abuse of power.

4. *The object of the contract is illegal.* If the agreements challenged by QVC were for the purpose of accomplishing the merger between Paramount and Viacom, they should not be void or invalid for illegality. There was no allegation in *Paramount* that the merger itself was an illegal end. The merger of two corporations is specifically permitted by statute in Delaware,[156] so Paramount's intention to accomplish the merger with Viacom would not raise any issue of enforceability based on illegality. However, if the agreements were intended to prevent other bidders from making competing offers, QVC could legitimately argue that they operated to its detriment. Perhaps this would support a claim that the contracts, if not illegal, were at least against public policy. As discussed elsewhere in this article, however, QVC's standing to make such a claim is questionable; this claim belongs to the Paramount shareholders rather than the disappointed bidder.[157]

5. *The conduct required to achieve the contract's ends would be illegal.* The Delaware Supreme Court distinguished between valid ends and valid means.[158] It reiterated that no-shop provisions and other defenses are not per se illegal in Delaware, but stated that they become "impermissible" when a *Revlon* auction duty arises.[159] The court decided

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acquired any vested contract rights against Paramount. "Viacom, a sophisticated party with experienced legal and financial advisors, knew of (and in fact demanded) the unreasonable features of the Stock Option Agreement." *Paramount*, 637 A.2d at 51. However, unconscionability is generally characterized by unequal bargaining power. *See* RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. d (1981) (stating that unconscionability may be found where there is "gross inequality of bargaining power, together with terms unreasonably favorable to the stronger party"). The opinion does not indicate that Paramount was for some reason overpowered by Viacom or at any bargaining disadvantage. If the court is suggesting that Viacom took advantage of Paramount, it does not indicate why it believes that Paramount was not able to hold its own in the negotiations.

[156]*See* DEL. CODE ANN. tit. 8, § 251(a) (1991).

[157]*See infra* text accompanying notes 209-16.

[158]*Paramount*, 637 A.2d at 48-49. The court unequivocally rejected the Paramount directors' contention that they could not look for other bidders because of the no-shop provision:

> Such provisions, whether or not they are presumptively valid in the abstract, may not validly define or limit the directors' fiduciary duties under Delaware law or prevent the Paramount directors from carrying out their fiduciary duties under Delaware law. To the extent such provisions are inconsistent with those duties, they are invalid and unenforceable.

Id. at 48.

[159]*Id.* at 49 n.20 (citing *Revlon*, 506 A.2d at 184).

that the stock option agreement contained "draconian" features and was agreed to in violation of the Paramount board's fiduciary duties.[160] It also determined that the no-shop provision attempted to bind the hands of Paramount's directors so that it limited their ability to exercise their fiduciary duties.[161] The court asserted that, under Delaware law, a board of directors may not contract away its fiduciary obligations.[162] Therefore, a contract that "purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties . . . is invalid and unenforceable."[163]

C. *Power of Corporations to Contract and* Ultra Vires

Delaware law provides that a corporation has the general power to do anything permitted by law or by its certificate of incorporation[164] and has the specific power to, among other things, own property and enter into contracts.[165] Although *ultra vires*[166] was once a fertile field for

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[160]*Id.* at 51.
[161]*Id.*
[162]*Paramount*, 637 A.2d at 51. *See supra* text accompanying notes 127-30.
[163]*Paramount*, 637 A.2d at 51.
[164]DEL. CODE ANN. tit. 8, § 121(a) (1991).
General powers.

(a) In addition to the powers enumerated in § 122 of this title, every corporation, its officers, directors and stockholders shall possess and may exercise all the powers and privileges granted by this chapter or by any other law or by its certificate of incorporation, together with any powers incidental thereto, so far as such powers and privileges are necessary or convenient to the conduct, promotion or attainment of the business or purposes set forth in its certificate of incorporation.

[165]DEL. CODE ANN. tit. 8, § 122 (1991).
Specific powers.
Every corporation created under this chapter shall have power to:

. . . .

(4) Purchase, receive, take by grant, gift, devise, bequest or otherwise, lease, or otherwise acquire, own, hold, improve, employ, use and otherwise deal in and with real or personal property, or any interest therein, wherever situated, and to sell, convey, lease, exchange, transfer or otherwise dispose of, or mortgage or pledge, all or any of its property and assets, or any interest therein, wherever situated;

. . . .

(8) Conduct its business, carry on its operations and have offices and exercise its powers within or without this State;

. . . .

(13) Make contracts, . . . incur liabilities, borrow money . . ., issue its notes, bonds and other obligations, and secure any of its obligations by mortgage, pledge or other encumbrance of all or any of its property, franchises

litigation, state corporation statutes now permit, and incorporators routinely include, extremely broad powers and purposes clauses in the articles or certificate of incorporation. Indeed, many states now include broad default rules in their corporation laws so that the corporation's governing documents need not enumerate the corporation's powers or purposes. For instance, the Model Business Corporation Act provides that a corporation "has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation."[167] These provisions make it difficult, if not impossible, for shareholders to successfully claim that their corporation has taken actions or entered into transactions that are beyond its power. Delaware law provides for action by shareholders (but not third parties) if a corporation acts outside of its power or capacity,[168] but the law has rarely been invoked.[169]

Even if its certificate of incorporation authorizes broad powers, a corporation's power to act may be restricted by the concept of corporate purpose. The Delaware Code grants power and privileges to the corporation and its directors "so far as such power and privileges are necessary or convenient to the conduct, promotion or attainment of the business or purposes set forth in [the corporation's] certificate of

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and income . . . .

[165]*See* DEL. CODE ANN. tit. 8, § 124 (1991). *Ultra vires*, literally, beyond the power, refers to acts outside the scope of a corporation's power as defined by statute and its articles of incorporation.

[167]MODEL BUSINESS CORP. ACT. § 3.01(a) (1984).

[168]The Delaware Code provides in part:

> In a proceeding by a stockholder against the corporation to enjoin the doing of any act or acts. . . . If the unauthorized acts . . . are . . . pursuant to any contract to which the corporation is a party, the court may, if all of the parties to the contract are parties to the proceeding and if it deems the same to be equitable, set aside and enjoin the performance of such contract, and in so doing may allow . . . compensation . . . for the loss or damage . . . which may result from . . . [the injunction] . . . but anticipated profits . . . [are not recoverable].

DEL. CODE ANN. tit. 8, § 124 (1991). The Model Business Corporation Act also deals with the doctrine of *ultra vires*. Third parties may not challenge the "validity of corporate action . . . on the ground that the corporation lacks or lacked power to act," but a shareholder may sue to enjoin an unauthorized corporate act, and

> the court may enjoin or set aside the act, if equitable and if all affected persons are parties to the proceeding, and may award damages for loss (other than anticipated profits) suffered by the corporation or another party because of enjoining the unauthorized act.

MODEL BUSINESS CORP. ACT § 3.04 (1984 & Supp. 1996).

[169]A LEXIS search of Delaware cases revealed no citations to § 124.

incorporation."[170] Therefore, even if a corporation's certificate of incorporation provides, as many do, that the corporation exists for "any lawful purpose,"[171] this provision of the Delaware Code may act as a check on the corporation's power. Courts and commentators have noted that in a capitalistic economy, business corporations exist for the purpose of creating wealth for their owners, the shareholders.[172] Consequently, even if the certificate of incorporation appears to grant unrestricted power to the corporation, a convincing argument can be made that the power exists only to the extent that it is exercised in furtherance of creating shareholder wealth. In *Paramount*, then, it would be possible to craft an *ultra vires* argument if the contracts entered into between Paramount and Viacom were not for the purpose of creating shareholder wealth.

Aside from the fact that the *Paramount* court did not pursue this rationale, it is problematic. The Paramount board believed the contracts between Paramount and Viacom *would* create shareholder wealth.[173] The court did not deny this; it simply concluded that the Viacom merger was less valuable to shareholders than the QVC offer, and that the Paramount board was mistaken in its evaluation of the merits of the transactions because it failed to fully investigate the QVC offer.[174] Therefore, even under a corporate purpose analysis, one could argue that as long as the Viacom transaction promised to provide any increased value for the shareholders, it was not beyond the power of the corporation to enter into it.

Using a corporate purpose analysis to determine *ultra vires* questions could lead to an inquiry into standard of review. For instance, should a court find an act to be *ultra vires* if it is only ascertained after

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[170]DEL. CODE ANN. tit. 8, § 121(a) (1991).

[171]A Delaware corporation "may be incorporated or organized . . . to conduct or promote any lawful business or purposes . . . ." DEL. CODE ANN. tit. 8, § 101(b) (Supp. 1991). A corporation's certificate of incorporation must set forth "[t]he nature of the business or purposes to be conducted or promoted. It shall be sufficient to state . . . that the purpose of the corporation is to engage in any lawful act or activity . . . ." *Id.* § 102(a)(3).

Chapter 3 of the Model Business Corporation Act governs the purposes and powers of corporations. A corporation "has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation." MODEL BUSINESS CORP. ACT § 3.01(a) (1984). A corporation "has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs . . . ." *Id.* § 3.02.

[172]*See, e.g.*, Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."); *see generally* ROBERT C. CLARK, CORPORATE LAW 678 (1986) ("[F]rom the traditional legal viewpoint, a corporation's directors and officers have a fiduciary duty to maximize shareholder wealth . . . .").

[173]*Paramount*, 637 A.2d at 49-50.

[174]*Id.*

the fact that the act did not further the corporation's purpose? Should the plaintiff have to prove that the directors did not reasonably believe they were furthering the corporation's purpose when they took the action? What if the directors reasonably believed the action would further the corporation's purpose but in fact it did not? If a tort-like analysis is appropriate, then courts should presumably examine the reasonableness of the board's actions at the time they were taken. But if the analysis focuses on the power of the corporation to act in the first instance, courts might be forced to evaluate the validity of actions based on their outcome, rather than their reasonable prospects.

D. *Power of the Board to Manage the Corporation*

1. Authority to Act

The *Paramount* case did not involve a limitation on the corporation's power or authority; instead, it focused on the power and authority of the directors to bind the corporation.[175] State corporation statutes give the board of directors the power and authority to manage the "business and affairs" of the corporation.[176] The board's authority to manage the corporation is commonly understood to be limited by notions of corporate purpose,[177] by the fiduciary duties imposed on directors

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[175]*See id.* at 48-51.

[176]Although the wording differs from state to state, the meaning of the statutes is similar across jurisdictions. For example, California's corporate law provides that "[s]ubject to [limited exceptions], the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board." CAL. CORP. CODE § 300(a) (West 1990). Similarly, Delaware law provides that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation." DEL. CODE ANN. tit. 8, § 141(a) (1994). Finally, the Model Business Corporation Act states, "All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors . . . ." MODEL BUSINESS CORP. ACT § 8.01(b) (Supp. 1996).

[177]*See supra* notes 166-72 and accompanying text. Although directors generally have broad statutory powers, they too may be limited by the notion of corporate purpose. If the board of directors exists to accomplish the corporation's purposes, then to the extent a directorial action does not or is not calculated to maximize shareholder wealth, perhaps it is beyond the power or authority of the board. Cf. *Dodge*, 170 N.W. at 684, which states:

> It is said by appellants that the motives of the board members are not material and will not be inquired into by the court so long as their acts are within their lawful powers. . . . [I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that, if the avowed purpose of the defendant

either by statute or common law,[178] and by authority reserved to the shareholders.[179]

Several commentators have suggested that some cases in which courts have invalidated directorial action are better explained as based on lack of directorial power than breach of fiduciary duty.[180] Although state

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> directors was to sacrifice the interests of shareholders, it would not be the duty of the courts to interfere.

Id.

[178]The Delaware statute does not spell out these fiduciary duties, but the Delaware courts have made it clear that directors owe to the corporation and its shareholders duties of "care, loyalty, and good faith." *See, e.g.*, Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1164 (Del. 1995); Rovner v. Health-Chem Corp., No. 15,007, 1996 Del. Ch. LEXIS 83 (Del. Ch. July 3, 1996); Giammalvo v. Sunshine Mining Co., No. 12,842, 1994 Del. Ch. LEXIS 6 (Del. Ch. Jan. 31, 1994), *reprinted in* 19 DEL. J. CORP. L. 1203 (1994).

Other jurisdictions similarly articulate the duties. *See, e.g.*, Long v. Lampton, 922 S.W.2d 692, 698 (Ark. 1996) ("Directors, officers and shareholders of a corporation owe fiduciary duties of care, good faith and loyalty to each other."); Buitekant v. Zotos Corp., No. CV94-0135874, 1996 Conn. Super. LEXIS 440, at *9 (Conn. Super. Ct. Feb. 20, 1996) ("Corporate officers and directors owe a corporation and its minority shareholders a fiduciary duty. Fiduciaries owe duties of good faith, loyalty and due care.") (citations omitted).

But see HB Korenvaes Invs., L.P. v. Marriott Corp., No. 12,922, [1993 Transfer Binder] Fed. Sec. L. Rep. ¶ 97,728, at 97,441 (Del. Ch. June 9, 1993), *reprinted in* 19 DEL. J. CORP. L. 736 (1994), for a slightly different articulation ("The proposed transaction is also said to constitute a breach of a fiduciary duty of loyalty and care and of the contractual obligations of good faith and fair dealing.").

The Model Business Corporation Act spells out some of the directors' fiduciary duties:

> **§ 8.30 General Standards for Directors**
>
> (a) A director shall discharge his duties as a director, including his duties as a member of a committee:
>
> (1) In good faith;
>
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
>
> (3) in a manner he reasonably believes to be in the best interests of the corporation.

Section 8.30 arguably does not cover the duty of loyalty, but § 8.31 deals with it implicitly by instructing directors how to deal with transactions in which they have a conflict of interest. MODEL BUSINESS CORP. ACT. §§ 8.30(a), 8.31 (1984). Note that §§ 8.31 and 8.32 are superseded by new Subchapter F, §§ 8.60-8.63. As did § 8.31, these new provisions deal with conflicts of interest and thus implicitly concern the duty of loyalty.

[179]State laws generally give shareholders the right to vote on certain matters, including election of the board of directors, amendment of the articles of incorporation, and approval of major transactions such as mergers and sales of substantially all of the corporation's assets. *See, e.g.*, MODEL BUS. CORP. ACT § 7.28 (1984 & Supp. 1996) (election of directors), § 10.03 (amendment of articles), §§ 1101, 1103 (mergers), § 12.02 (sale of assets); DEL. CODE ANN. tit. 8, § 216 (1991) (election of directors), § 242 (amendment of certificate of incorporation), § 251 (mergers), § 271 (1991 & Supp. 1995) (sale of assets).

[180]*See, e.g.*, Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71, 74-75 (1989).

laws generally give directors the power to initiate or unilaterally reject merger transactions, the decision to actually engage in a merger or consolidation, and thus transfer control of the corporation, belongs to the shareholders.[181] To accomplish a merger, but the board of directors must first approve a plan of merger and then submit it to the shareholders for a vote.[182] Directorial action is thus required to initiate a merger, but the board lacks the power to consummate a merger without shareholder approval.

Some commentators posit that directors' power to defend against takeovers should also be limited, and in particular, that directors should have no power to defend against tender offers, because tender offers are made directly to shareholders, with no director authorization required. Therefore, to accept or reject a tender offer is solely a shareholder decision and is not a proper subject for board intervention.[183]

Such limitation is not imposed by statute, however, and as discussed in Part III.A.1 above, it is not clear that the courts would or should be willing to limit directorial power in this manner.

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[181]But, perhaps surprisingly, directors may have the authority to unilaterally reject a merger even after shareholder approval. *See, e.g.*, CAL. CORP. CODE § 1105 (West 1990) ("The board may, in its discretion, abandon a merger, subject to the contractual rights, if any, of third parties, including other constituent corporations, without further approval by the outstanding shares at any time before the merger is effective.") (citation omitted); DEL. CODE ANN. tit. 8, § 251(d) (Interim Supp. 1995) ("Any agreement of merger . . . may contain a provision that at any time prior to the time that the agreement . . . becomes effective . . ., the agreement may be terminated by the board of directors of any constituent corporation notwithstanding approval of the agreement by the stockholders . . . .").

[182]DEL. CODE ANN. tit. 8, § 251 (b)-(c) (Supp. 1994).

[183]*See, e.g.*, Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239 (1990) (asserting that in negotiated transactions involving a change of control of the corporation, directors should not be permitted to enter into exclusivity provisions or lock-ups that deter competing bids); Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CAL. L. REV. 1671 (1985) (examining shareholder participation in corporate governance and shareholder relief from coerced acceptance of majority and managerial decisions); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 865-75 (1981) (arguing that in tender offers, target directors should be limited to providing information to shareholders to assist them in making informed decisions as to whether to tender, and bargaining to secure a higher offer); Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 320 (1987) (proposing that only independent directors should be able to consider a merger proposal and that the "directors' power to enter into exclusive merger covenants without the prior approval of target shareholders" should be limited); Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71 (1989) (contending that target directors should have the power to erect takeover defenses only to the extent that such defenses do not usurp the shareholders' power to transfer control).

2. Agency and Trust Theories

a. *Sources and Scope of Directorial Power and Authority*

Since a corporation is not a natural person, it cannot act for itself. Therefore, statutes provide that a corporation's business and affairs are managed by its board of directors.[184] Although the board may delegate some of its powers and responsibilities to committees,[185] individual directors do not otherwise have the authority to act on behalf of the corporation — only the board as an entity can act for the corporation.[186]

Although the text of section 141 of the Delaware General Corporation Law refers to both the "power" and the "authority" of the board of directors,[187] the statute does not distinguish between the two concepts, nor does it define either in terms of the directors' ability to make decisions or take action on behalf of the corporation.[188]

The term authority is commonly thought of in the context of the law of agency, and the Restatement (Second) of Agency defines both power and authority.[189] Power refers to an agent's ability or capacity to produce a change in a legal relation (whether or not the principal approves of the change), and authority refers to the power given

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[184]*See supra* Part III.D.

[185]*See* DEL. CODE ANN. tit. 8, § 141(c) (Interim Supp. 1995).

[186]Historically, the law required an actual meeting of the board of directors to take action. Even if all directors agreed, action taken without a meeting was invalid. *See* Baldwin v. Canfield, 1 N.W. 261 (Minn. 1879). Modern statutes permit boards of directors to act through telephonic meetings or by unanimous written consent, lowering the procedural barriers to action. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(f), (i) (1991).

[187]DEL. CODE ANN. tit. 8, § 141(c) (Interim Supp. 1995). In subsection (c), the statute provides that, within statutory limits excepting major transactions such as amendment of the corporation's certificate of incorporation or adoption of a merger agreement, board-appointed committees, to the extent the board provides, "shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation." *Id.*

[188]Delaware case law also fails to distinguish between power and authority. *E.g.*, Stroud v. Grace, 606 A.2d 75, 95 (Del. 1992) ("They claim that the corporation law vests the directors with the authority to administer elections, and that the trial court should not have assumed on a purely speculative basis that the incumbent directors would exercise their powers inequitably."); Oberly v. Kirby, 592 A.2d 445, 458 (Del. 1991) ("Beyond the power to vote for directors and to participate in annual meetings, shareholders have limited direct authority."); *Revlon*, 506 A.2d at 181 ("The directors' general broad powers to manage the business and affairs of the corporation are augmented by the specific authority . . . permitting the company to deal in its own stock."); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1353 (Del. 1985) (footnote omitted) ("[W]e note the inherent powers of the Board conferred by 8 Del. C. §141(a) . . . also provides the Board additional authority upon which to enact the Rights Plan.").

[189]RESTATEMENT (SECOND) OF AGENCY §§ 6, 7 (1957).

(permission granted) to the agent by the principal to affect the legal relations of the principal; the distinction is between what the agent *can* do and what the agent *may* do.[190]

b. *Agency Concepts*

Agency principles are relevant to at least two issues in the *Paramount* case: the Paramount board's power and authority to cause Paramount to enter into binding contracts with Viacom, and QVC's standing to sue Paramount to invalidate the contracts. Although they are technically neither agents nor trustees, directors have been described as agents of the corporation and its shareholders,[191] as trustees,[192] and as fiduciaries.[193]

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[190]The Restatement contains the following definitions:

> § 6. Power. A power is an ability on the part of a person to produce a change in a given legal relation by doing or not doing a given act.
>
> § 7. Authority. Authority is the power of the agent to affect the legal relations of the principal by acts done in accordance with the principal's manifestations of consent to him.

Comment a to § 7 notes that:

> the term "authority" has been used by the courts in a variety of ways. Sometimes it has been used to denote the factual giving of consent by the principal, without reference to the creation of a legal power; sometimes it has been used broadly to indicate the power which an agent has when there is apparent authority, estoppel or other basis for making the principal a party to the transactions.

RESTATEMENT (SECOND) OF AGENCY (1957).

[191]*E.g.*, Illinois Valley Acceptance Corp. v. Martin, 531 F. Supp. 737, 741 (C.D. Ill. 1982) ("In some respects, an officer or director of a corporation is an agent of the corporation."); Hackford v. First Sec. Bank of Utah, 521 F. Supp. 541, 551 n.4 (D. Utah 1981) ("A corporation can act only through its agents, normally directors."); Dawkins v. Mitchell, 90 So. 396, 398 (La. 1922) ("The directors of the bank were its agents, charged under the law with an implied trust to use its funds only for the purposes permitted by law, and to preserve them for its creditors and stockholders . . . .").

[192]*E.g.*, Petty v. Penntech Papers, 347 A.2d 140, 143 (Del. 1975) ("Clearly directors of a corporation stand in a position of trustees with the stockholders . . . and the utmost good faith and fair dealing are required of them, especially where their individual interests are concerned."); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its shareholders."); Bowen v. Imperial Theatres, Inc., 115 A. 918, 922 (Del. 1922) ("Directors of a corporation are frequently spoken of as its trustees. Their acts are scanned in the light of those principles which define the relationship existing between trustee and cestui que trust.").

[193]*E.g.*, Popkin v. Dingman, 366 F. Supp. 534, 539 (S.D.N.Y. 1973) ("Directors are not agents of the shareholders who elect them. They are fiduciaries with duties running primarily to the corporation.") (citing HARRY G. HENN, LAW OF CORPORATIONS 415 (2d ed. 1970)).

Power and authority of the board. An agent is one who acts on behalf of a principal, and subject to the principal's control.[194] Agents have the power and authority to incur legal obligations that bind their principals.[195] This authority may be either expressly or impliedly communicated by the principal to the agent (actual authority), or expressly or impliedly communicated by the principal to a third party (apparent authority).[196] Agents frequently have power that exceeds their authority to act on behalf of their principals (inherent agency power).[197] Although acts outside an agent's actual authority may be wrongful, and may subject the agent to personal liability to the principal, the acts may legally bind the principal vis-à-vis third parties.[198]

Concomitant with their powers, agents have duties. They owe fiduciary duties to their principals of care, obedience, and loyalty,[199] and must put their principals' interests ahead of their own.[200]

Like agents, corporate directors agree to act in furtherance of shareholder interests, and also like agents, directors have the power and authority to act on behalf of the corporation and to bind the corporation to legal obligations.[201] The Restatement notes that board members "resemble agents in that they act on behalf of others and are fiduciaries owing duties of loyalty and care" to the corporation.[202] However, the Restatement maintains that there is at least one significant difference; corporate boards of directors are not agents of either the corporation or its shareholders,[203] because they are not subject to the control of a principal.[204] Individual directors are even less like agents than are boards of directors because, unlike the board as a whole, individual directors have no authority to act on behalf of the corporation.[205]

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[194]RESTATEMENT (SECOND) OF AGENCY § 1 (1957).

[195]*Id.* §§ 7-8.

[196]*Id.*

[197]*See id.* § 8A.

[198]*See, e.g.,* Lind v. Schenley Indus., Inc., 278 F.2d 79 (3d Cir. 1960) (en banc) (holding employer liable under the principle of apparent authority for the acts of its agent); *cf. infra* note 210.

[199]RESTATEMENT (SECOND) OF AGENCY §§ 379, 385, & 387-98 (1957).

[200]*Id.* § 387. *See* Meinhard v. Salmon, 164 N.E. 545 (1928) (note the language in this case refers to partners and co-venturers, not specifically to agents).

[201]*See* DEL. CODE ANN. tit. 8, § 141(a) (1991); RESTATEMENT (SECOND) OF AGENCY § 14 C cmt. a (1957).

[202]RESTATEMENT (SECOND) OF AGENCY § 14 C cmt. a (1957).

[203]*Id.* § 14 C, which states: "Neither the board of directors nor an individual director of a business is, as such, an agent of the corporation or of its members." *Id.*

[204]*Id.* § 14 C cmt. a ("A board of directors differs from an agent in that it is not subject to another's control except with regard to the appointment and removal of its members.").

[205]*Id.* § 14 C cmt. b.

The *Paramount* court found that Paramount's directors breached their duty of care to the shareholders by failing to investigate QVC's offer thoroughly, and it thus invalidated Paramount's agreements with Viacom.[206] Even if the directors breached their fiduciary duties, and as a result acted outside the scope of their actual authority, would they not have the apparent authority or inherent power to cause their corporation to enter into binding contracts? Perhaps the *Paramount* decision intimates that the Delaware court believes that, unlike agents or trustees, directors have no apparent authority and no inherent power — they have only actual authority, derived from statute and from specific agreements with shareholders. Perhaps the court conceives of that such actual authority as broad enough to do whatever is necessary to manage the corporation, but limited by its purpose: maximizing the value of the corporation for the benefit of the shareholders. The notion of fiduciary duties, then, would simply be a conceptual way to describe how a board of directors must accomplish this value maximization — not through flashes of brilliance or inspiration or speculation, but by thorough investigation and carefully considered decisions. If this is indeed what the court means, it contradicts other cases that encourage directors to take some risks in the service of increasing the potential for profit.[207]

QVC's standing to sue. Agency doctrines also pose a puzzle when QVC's standing to sue is considered. The Restatement (Second) of Agency provides a laundry list of remedies available for an agent's breach of duty, breach of contract, or tortious conduct.[208] The principal can sue the agent directly under some circumstances, and can deny liability to third parties for acts beyond the agent's power or authority.[209] But these are remedies available to the principal. In this situation, QVC cannot be considered a principal. Although the *Paramount* court said that it was invalidating and enjoining the performance of contracts based on

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[206]*QVC*, 635 A.2d at 1270.

[207]*See infra* text accompanying note 217.

[208]*See generally* RESTATEMENT (SECOND) OF AGENCY §§ 399-409 (1957) (setting out remedies available to a principal for an agent's violation or threatened violation of his duties, the various liabilities an agent faces for violating these duties, and when a principal can properly terminate employment for such violation).

[209]See RESTATEMENT (SECOND) OF AGENCY § 140, which provides that a principal's liability on a transaction between the agent and a third party "may be based upon the fact that: (a) the agent was authorized; (b) the agent was apparently authorized; or (c) the agent had a power arising from the agency relation and not dependent upon authority or apparent authority." In the absence of some other ground for asserting that the principal should be liable to the third party (e.g., ratification or estoppel), the principal is not liable to third parties under agency principles for acts by an agent that are outside the agent's power and authority. *See* RESTATEMENT (SECOND) OF AGENCY §§ 100, 103, 140, 141 (1957).

the Paramount directors' violation of their fiduciary duties, the purpose of QVC's action was not to enforce fiduciary duties owed to it in its capacity as a shareholder.[210] Other Paramount shareholders joined with QVC in the suit, but QVC's action was clearly in its capacity as a suitor, not a shareholder.[211]

Although, according to the Restatement, Paramount's board was neither the agent of the shareholders nor of the corporation, if the board can be understood as similar to an agent of either the corporation or its shareholders, then the *Paramount* case would stand for the proposition that an outsider can enforce fiduciary obligations between an agent and a principal. In *Paramount*, a third party (QVC) sought to enjoin and invalidate contracts between the corporation/principal (Paramount) and another party (Viacom). The court found for the plaintiffs on the ground that, due to the board's (agent's) lack of care or diligence, it failed to obtain the best deal for the shareholders/principal, i.e., a contract with the third party.[212] How does a party outside the principal/agent relationship have standing to question the agent's fidelity to the principal?

Perhaps there is a way to analyze the facts to suggest that, even though Paramount's board was not QVC's agent, Paramount owed a duty to QVC. Perhaps Paramount owed a duty of fair dealing, or a duty not to favor a competing bidder.[213] If such a duty to QVC existed, the court

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[210]QVC actually owned 1000 shares of Paramount stock at or shortly after the time that it filed its action on October 21, 1993. *See* QVC's Schedule 14D-1, dated October 27, 1993, and filed with the Securities and Exchange Commission on October 28, 1993. However, the QVC's lawsuit was to redress harm it suffered as a suitor, not as a shareholder. *Paramount*, 637 A.2d at 36.

[211]The Delaware courts do not seem to have focused on this issue, although at least one opinion has recognized that it exists. *See* City Capital Assocs. v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988). CCA, a bidder, brought suit to require Interco to remove defenses to CCA's offer. *Id.* at 794. The court noted that, while CCA was in fact an Interco shareholder, it had brought the suit because it was a bidder.

> The question of a bidder/shareholder's right to enforce fiduciary duties owed to shareholders does not often arise as a practical matter, because there are typically several stockholder class actions that proceed on the same schedule as an action by the bidder. Therefore, to my knowledge, this court has not been required to focus upon either the question whether a bidder may enforce such rights, *qua* stockholder, or whether a bidder may, at least in some circumstances, have some other state law source of right to enforce duties owed to shareholders.

Id. at 800. The court determined that CCA's interests were not in conflict with those of the other Interco shareholders, and thus allowed the suit to proceed, basing CCA's standing on its status as an Interco shareholder. *Id.*

[212]*Paramount*, 637 A.2d at 49-50.

[213]In *Revlon*, the Delaware court commented on disparate treatment of bidders by a target corporation.

did not rely on it. The only transgression noted by the court was a breach of duty to Paramount's shareholders — that Paramount's board failed to use sufficient care in investigating the offers to try to get the best price for its shareholders, and thus ended up making decisions based on insufficient information.[214] Obviously, QVC's motive for bringing suit was not altruistic; it did not sue to vindicate the Paramount shareholders' interests. But why should QVC's desire to acquire Paramount give it the legal right to disrupt a deal between Paramount and Viacom?[215]

In another context, suppose Agent determines that Principal needs new widgets. Although the best and cheapest widgets happen to be sold by manufacturer X, Agent negligently fails to discover X's widgets and buys inferior widgets from manufacturer Y at a higher price. In this scenario, Principal may have a negligence action against Agent, but does

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> Favoritism for a white knight to the total exclusion of a hostile bidder might be justifiable when the latter's offer adversely affects shareholder interests, but when bidders make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions. Market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity.

Revlon, 506 A.2d at 184. As in *Paramount*, the plaintiff in *Revlon* was a hostile bidder suing to enjoin defenses raised to ward off its takeover attempt, not for violation of duties owed to it in its capacity as a Revlon shareholder. But although both courts granted relief to the plaintiffs, the opinions focus on duties owed by the board to the shareholders, with no mention of any duties owed to the hostile bidders in their capacity as such.

[214] *Paramount*, 637 A.2d at 49-50.

[215] *Cf.* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 4-5 (1977). Chris-Craft and Bangor Punta Corporation were competing bidders for Piper Aircraft Corporation. With the assistance of Piper's management, Bangor Punta eventually won control of Piper. *Id.* Chris-Craft asserted that both Piper and Bangor Punta had violated § 14(e) of the Williams Act in resisting Chris-Craft's tender offer. *Id.*

Section 14(e) is an antifraud provision that makes it "unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading." 15 U.S.C. § 78n(e) (1994). However, § 14(e) does not expressly provide a private right of action for damages, so the question before the Supreme Court was whether Chris-Craft had the right to sue. *Piper*, 430 U.S. at 25-26.

The Court determined that the Williams Act was enacted for the protection of investors, and held that Chris-Craft, as a disappointed tender offeror, was not a member of the class "for whose *especial* benefit the statute was enacted." *Id.* at 37 (quoting Cort v. Ash, 422 U.S. 66, 78 (1975)). Therefore, it was not entitled to a private right of action under the statute. *Id.*

Piper could be analogized to *Paramount* by considering the purpose of the fiduciary duties imposed on corporate directors. If they are not intended for the "especial benefit" of hopeful acquirers, then perhaps it is inappropriate for courts to permit a disappointed bidder to use them as a basis for a lawsuit.

manufacturer X, who did not get the business, have an action against either Agent or Principal? Or manufacturer Y? Surely not. In the absence of a contract between Principal and X, it is unclear how X could establish any standing to sue.

This hypothetical situation parallels the *Paramount* court's description of the Paramount board's actions. The board determined that Paramount needed to engage in a strategic combination with another company, and the board negotiated a merger with Viacom. QVC was willing to offer Paramount a higher price than Viacom had agreed to pay, but the Paramount board negligently failed to investigate and realize the value of the QVC offer, so the Paramount shareholders would have realized lower value had the Viacom merger gone through as planned. An agency theory does not provide any basis for QVC's standing to sue.

Would a third party beneficiary analysis make any sense — could manufacturer X be understood as the intended beneficiary of the contract between Principal and Agent? Probably not; Principal's intent is to benefit Principal, not manufacturer X, and any benefit accruing to X is merely incidental. Here, QVC was certainly not the intended beneficiary of any express or implied contract between the Paramount board and the company or its shareholders. Paramount was not pursuing a business combination in order to benefit its merger partner, whomever that might be.

Perhaps this standing analysis does not make sense in the *Paramount* case because directors are not exactly agents. This may be an example of how agency analysis does not quite work in the corporate board setting. But even if that is so, putting agency law aside, one can fairly infer from *Paramount* that a plaintiff who is not suing in its capacity as a shareholder may have the power to enforce the fiduciary duties that corporate directors owe to the shareholders.

c. *Trust Concepts*

According to the Restatement (Second) of Trusts, corporate officers and directors are not trustees with respect to either the corporation or its shareholders, because they do not hold title to the corporation's property.[216] Directors, like trustees, have fiduciary duties of loyalty, care, and good faith. However, directors' duties differ in significant ways from those of trustees. As explained by the Delaware Supreme Court:

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[216] RESTATEMENT (SECOND) OF TRUSTS § 16A (1957); *see also* RESTATEMENT (SECOND) OF TRUSTS § 16A cmt. a (1957) ("The officers and directors of a corporation do not hold the title to the property of the corporation and therefore are not trustees.").

> Corporate directors are responsible for often complex and demanding decisions relating to the operations of business institutions. The nature of business competition insures that these directors will often be required to take risks with the assets they manage. Indeed, an unwillingness to take risks prudently is inconsistent with the role of a diligent director. The trustee's role is, classically, quite different. The role of the trustee is prudently to manage assets placed in trust, within the parameters set down in the trust instrument. The classic trusteeship is not essentially a risk taking enterprise, but a caretaking one. Hence, while trustees may be surcharged for negligence, a corporate director is only considered to have breached his duty of care in instances of gross negligence.
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> The duty of loyalty of a trustee also developed differently than that of a corporate director. Traditionally a trustee could not enter self-dealing transactions, even if the transaction was in all other respects, fair. Modernly at least, corporate directors may negotiate transactions with respect to which they "stand on both sides" if the terms of the deal, and the process by which it was negotiated are entirely fair . . . .
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> These distinctions between trust law and corporate law, while of tone and tenor, are important. They do suggest that, insofar as negligence uncomplicated by a breach of loyalty is concerned, important policies having to do with the nature of the legal institutions of trust and of corporation require that the corporate liability rule should certainly remain less stringent than that of the trust law.[217]

As recently as 1995, then, the Delaware court reiterated that gross negligence was not the same thing as negligence, and that directors' duties would be measured under the former standard, not the latter. There is substantial case law supporting the proposition that directors are not liable for simply making mistakes, even if those mistakes result in substantial costs to the corporation and its shareholders.[218] The Second

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[217]Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1148 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995).

[218]*See, e.g.*, Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982), *cert. denied sub nom.*

Circuit Court of Appeals noted that "shareholders to a very real degree voluntarily undertake the risk of bad business judgment."[219] It suggested that, "because potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions."[220]

In a 1940 case, the Supreme Court of New York considered whether bank directors had breached their fiduciary duties when they entered into a transaction that turned out to be a costly mistake.[221] Noting that bank directors are held to "stricter accountability" than directors of "an ordinary business corporation" because banks are entrusted with depositors' funds, the court nonetheless commented that

> clairvoyance is not required even of a bank director. The law recognizes that the most conservative director is not infallible, and that he will make mistakes, but if he uses that degree of care ordinarily exercised by prudent [directors] he will be absolved from liability although his opinion may turn out to have been mistaken and his judgment faulty.[222]

Neither courts nor shareholders are positioned to manage the affairs of a corporation. Even judges with substantial business sophistication are not as competent to decide business issues as a corporation's management, which is familiar with the day-to-day idiosyncrasies of the company and its industry. Similarly, shareholders are neither authorized by law nor capable (because of both lack of expertise and dispersion) of

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Citytrust v. Joy, 460 U.S. 1051 (1983) ("The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge."); Schlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. 1968), provides:

> [W]e do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision.

Id.; *see also* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("We are not, however, persuaded that we should interfere with the proposed expansion of the business. . . . The judges are not business experts."); Kamin v. American Express Co., 383 N.Y.S.2d 807, 811 (N.Y. Sup. Ct. 1976), *aff'd* 387 N.Y.S.2d 993 (N.Y. App. Div. 1976) ("It is not enough to allege, as plaintiffs do here, that the directors made an imprudent decision. . . . More than imprudence or mistaken judgment must be shown.").

[219] *Joy*, 692 F.2d at 885.

[220] *Id.* at 886.

[221] Litwin v. Allen, 25 N.Y.S.2d 667 (N.Y. Sup. Ct. 1940).

[222] *Id.* at 678.

managing a corporation's business operations. Therefore, courts have traditionally deferred to the judgment of a corporation's board of directors, even if the shareholders can demonstrate that a decision was unwise, unless shareholders can show either breach of the duty of loyalty or gross negligence. Shareholders elect directors to manage the company, and they can diversify their holdings or replace the board if they are concerned about risk. Accordingly, corporate directors should not be held to a trustee's high standard of care, but rather should be encouraged to take reasonable risks on behalf of the shareholders in order to maximize their potential profits.

IV. FIDUCIARY DUTY

In regards to Paramount and Viacom's argument that directors can place contractual limitations on their fiduciary duties, the *Paramount* court stated,

> To the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable. Despite the arguments of Paramount and Viacom to the contrary, the Paramount directors could not contract away their fiduciary obligations.[223]

A. *What Fiduciary Duties Are Owed and to Whom*

The Delaware Code does not specify the fiduciary duties owed by directors, but the courts have articulated them in a fairly consistent manner. Directors owe duties of loyalty, good faith, and care to the corporation and its shareholders.[224]

1. Duty of Loyalty

The duty of loyalty requires directors to put the interests of the corporation and its shareholders ahead of their own interests.[225]

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[223]*Paramount*, 637 A.2d at 51 (citation omitted).

[224]*See, e.g.*, *Paramount*, 637 A.2d at 43 ("'[D]irectors owe fiduciary duties of care and loyalty to the corporation and its shareholders'" (quoting *Mills Acquisition*, 559 A.2d at 1280)); *see also, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993); *Revlon*, 506 A.2d at 179 (Del. 1985); *Aronson*, 473 A.2d at 811; *Guth*, 5 A.2d at 510.

[225]*See, e.g.*, Bayer v. Beran, 49 N.Y.S.2d 2, 5 (N.Y. Sup. Ct. 1944) ("The concept of

Whenever there is a potential conflict of interest, directors are obliged to fully disclose the conflict and either abstain from participating in any decision which might benefit them at the expense of the shareholders, or bear the burden of proving that the transaction is entirely fair to the shareholders.[226] Failure to do so can subject any profit acquired by the director to a constructive trust in favor of the corporation.[227] In recent years, in order to minimize the opportunity for conflicts of interest, corporate boards formerly populated by directors affiliated with or employed by the company have given way to boards composed of a majority of independent, unaffiliated directors. In that way, decisions that might either benefit or disadvantage affiliated or "inside" directors may be made by unaffiliated or "outside" directors.[228]

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loyalty, of constant, unqualified fidelity, has a definite and precise meaning. The fiduciary must subordinate his individual and private interests to his duty to the corporation whenever the two conflict."); *Guth*, 5 A.2d at 510 ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests . . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.").

[226]*See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 710-11 (Del. 1983) (Delaware Supreme Court held that directors breached their duty of loyalty when they did not disclose their conflicts of interest and participated in a decision to merge UOP into the Signal Companies, Inc.). The court stated, "When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain." *Id.* at 710.

[227]*See Guth*, 5 A.2d at 510:

> If an officer or director of a corporation, in violation of his duty as such, acquires gain or advantage for himself, the law charges the interest so acquired with a trust for the benefit of the corporation, at its election, while it denies to the betrayer all benefit and profit. The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation. Given the relation between the parties, a certain result follows; and a constructive trust is the remedial device through which precedence of self is compelled to give way to the stern demands of loyalty.

[228]*See, e.g.*, *Unocal*, 493 A.2d at 955 (noting that proof of directors' good faith and reasonable investigation is "materially enhanced, as here, by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards"); *Aronson*, 473 A.2d at 812 (stating that disinterested directors are those who "neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally").

In *Paramount*, a majority of the Paramount board members were not employed by the company.[229] There was no finding that the Paramount directors breached their duty of loyalty to the company or its shareholders.[230]

2. Duty of Good Faith

Although the Delaware courts frequently include the duty of good faith in the litany of fiduciary duties alongside the duties of loyalty and care,[231] they have not described or explained this duty in nearly as much detail as the others. Delaware permits a corporation to include in its certificate of incorporation a provision to "eliminat[e] or limit[ ] the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty,"[232] but the corporation may not exculpate a director for breach of either the duty of good faith or the duty of loyalty.[233] Therefore, the provision will permit limitation of liability only for a breach of the duty of care. From this, one might deduce that good faith is more akin to loyalty than to care.[234] At least one court has suggested that good faith is equivalent to honesty in fact, a subjective standard requiring directors to act in accordance with what they believe to be true.[235] But another court suggests that good faith is more closely associated with diligence, or the duty of care.[236]

In *Paramount*, neither the chancery court nor the Delaware Supreme Court asserted that the Paramount directors failed to act in accordance with an honestly-held belief that the Viacom merger was more valuable than the QVC offer. Both courts, however, found that the

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[229]*QVC*, 635 A.2d at 1247.

[230]*Id.* at 1262 n.34.

[231]*See, e.g., Technicolor*, 634 A.2d at 361 (referring to a board's "triad[ ] of . . . fiduciary dut[ies] — good faith, loyalty, or due care").

[232]DEL. CODE ANN. tit 8, § 102(b)(7) (Supp. 1994).

[233]*Id.*

[234]*See also Technicolor*, 634 A.2d at 368 n.36 (quoting language that seems to suggest that good faith is related to loyalty: "[A] board's actions must be evaluated in light of relevant circumstances to determine if they were undertaken with due diligence [care] and good faith [loyalty]. If no breach of duty is found, the board's actions are entitled to the protection of the business judgment rule.") (quoting Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989)) (bracketed language added by *Cede* court).

[235]Hubbard v. Hibbard Brown & Co., 633 A.2d 345, 350 (Del. 1993) ("An optimistic prediction regarding a company's future prospects is not a 'falsehood' absent evidence that it was not made in good faith (i.e., not genuinely believed to be true) . . . .").

[236]*See Barkan*, 567 A.2d at 1288 ("[T]he crucial element supporting a finding of good faith is knowledge.").

directors were not diligent enough in ascertaining the value of QVC's offer.[237]

3. Duty of Care

The fiduciary duty of care requires directors to be diligent and to make inquiries before acting on behalf of the corporation. They must make reasonable efforts to ensure that their decisions are made with sufficient thought and information. Until *Smith v. Van Gorkom*,[238] there was a general perception among scholars and practitioners that although courts frequently mentioned the duty of care, it was an extremely unlikely source of director liability. The Delaware courts had previously determined that liability for breach of the duty of care would require plaintiffs to show that the directors had been grossly negligent.[239] Most corporate advisors and insiders believed this to mean that, to avoid liability, directors needed to come to board meetings and read the materials that were given to them. However, the Delaware Supreme Court sent shock waves through the corporate bar when it found Van Gorkom and the other directors of Trans Union Corporation personally liable for their failure to "act in an informed and deliberate manner."[240] Even though all of the Trans Union directors were intelligent, sophisticated people who knew their company well, and even though they came to meetings and read what was given to them, they did not demand sufficient information nor sufficient time to allow them to make an informed business judgment. The directors were liable despite the fact that, in keeping with Delaware precedent, the court imposed the relatively low standard of care of gross negligence.[241]

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[237] *QVC*, 635 A.2d at 1269; *Paramount*, 637 A.2d at 51.

[238] 488 A.2d 858 (Del. 1985). *See supra* note 57.

[239] *Aronson*, 473 A.2d at 812.

[240] *Van Gorkom*, 488 A.2d at 873. The court found that:

> [t]he directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the "sale" of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the "sale" of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency.

Id. at 874.

[241] *Aronson*, 473 A.2d at 812 ("While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence."); *see also Van Gorkom*, 488 A.2d at 873:

In *QVC*, the chancery court considered the duty of care. Although the court found that the Paramount board had been "patently unreceptive to gathering information" about other potential transactions from September 9, the chancellor found "no basis to criticize the sufficiency of the board's information or processes up to November 12, when QVC raised its offer to $90 . . . ."[242] Until that time, the court found that "if there were any arguable defects in the board's information-gathering process, they were immaterial . . . ."[243] But after that time, the chancery court concluded that the board failed in its duty of care obligation to "inform itself of all available material information."[244]

The Delaware Supreme Court made statements inconsistent with a gross negligence standard in its determination that the Paramount board had breached its duty of care. "In the sale of control context, the directors must focus on one primary objective — to secure the transaction offering the best value reasonably available to the shareholders. . . . In pursuing this objective, the directors must be *especially diligent*."[245] "[A] change of control imposes on directors the *obligation to obtain the best value* reasonably available to the stockholders . . . ."[246]

A negligence standard imposes a duty of reasonable care under the circumstances, so a gross negligence standard should require somewhat less than reasonable care. In the first example, the court requires more than reasonable care (especial diligence), and in the second, it imposes the even higher standard of reasonable results, not just reasonable process. However, the court does not acknowledge that its language is inconsistent with Delaware law regarding the standard to be applied in duty of care analysis.

> We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.
>
> In the specific context of a proposed merger of domestic corporations, a director has a duty under 8 Del. C. 251(b), along with his fellow directors, to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders.

Id. (footnotes and citations omitted).

[242] *QVC*, 635 A.2d at 1269.

[243] *Id.*

[244] *Id.* The court found that, "in this particular setting, instincts and sincere beliefs are not enough," and suggested that the board should have come forward with "quantitative valuation information" to support its judgment. *Id.* at 1269-70.

[245] *Paramount*, 637 A.2d at 44 (emphasis added).

[246] *Id.* at 46 (emphasis added).

4. Unitary Fiduciary Duty

In a recent article, Professors Lawrence Cunningham and Charles Yablon observed that the Delaware court appears to be moving toward an understanding of "Delaware fiduciary law as imposing on all corporate directors a single, highly general obligation of good faith and fair dealing based on reasonably informed judgment."[247] The authors based their thesis on the Delaware Supreme Court's decisions in two cases: *Paramount*[248] and *Cede & Co. v. Technicolor, Inc.*[249]

Like *Smith v. Van Gorkom*,[250] the *Technicolor* case involved a breach of the duty of care by directors considering a merger proposal.[251] The chancery court found that, even though directors had breached their duty of care in approving a merger with insufficient information, the merger price they approved was actually in excess of the value of Technicolor at the time, so plaintiffs were unable to prove the damages necessary in a tort suit.[252] Therefore, the chancellor ruled against plaintiffs.[253] The supreme court reversed, finding that once plaintiffs proved a breach of fiduciary duty, they had no obligation to prove damages — the burden would shift to the defendants to prove that the transaction was intrinsically fair to the shareholders.[254]

The authors note that, although the court enumerated the same list of fiduciary duties of directors as other courts have (good faith, loyalty, and due care), the *Technicolor* court departed from the traditional understanding that breach of the duty of care is really a tort issue rather than a fiduciary question.[255] "Technicolor represents an effort by the Delaware Supreme Court to remove doctrinal distinctions between duty of care liability and other breaches of fiduciary duty. . . . Just as in

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[247]*See generally* Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty Law After* QVC *and* Technicolor: *A Unified Standard (and the End of Revlon Duties?)*, 49 BUS. LAW. 1593, 1594 (1994) (analyzing Delaware fiduciary law).

[248]637 A.2d 34 (Del. 1994).

[249]634 A.2d 345 (Del. 1993).

[250]488 A.2d 858 (Del. 1985).

[251]*Technicolor*, 634 A.2d at 358-59.

[252]*Id.* at 350-51.

[253]*Id.*

[254]*Id.* at 367. The court found that the chancellor's requirement that Cinerama "prove a proximate cause relationship between the Technicolor board's presumed breach of its duty of care *and* the shareholder's resultant loss . . .[was] contrary to well-established Delaware precedent, irreconcilable with *Van Gorkom*, and contrary to the tenets of *Unocal* and *Revlon*. . . . ." *Id.*

[255]Cunningham & Yablon, *supra* note 247, at 1601.

interested director cases, and unlike negligence cases, proof of a breach of fiduciary duty alone is sufficient to justify intrinsic fairness review."[256]

B. *Impact of Breach of Fiduciary Duty on Power to Contract*

1. Restatement Provision on Impact of Breach of Fiduciary Duty on Validity of Contract

Section 193 of the Restatement (Second) of Contracts provides that "[a] promise by a fiduciary to violate his fiduciary duty or a promise that tends to induce such a violation is unenforceable on grounds of public policy."[257] Comment a to this provision notes that "[d]irectors and other officials of a corporation act in a fiduciary capacity and are subject to the rule stated in this Section."[258] However, cases that cite this section as authority involve attempts to enforce rights under contracts entered into in violation of fiduciary duty, largely in the context of a breach of loyalty rather than a breach of care.[259] Thus, if Viacom had attempted to enforce the stock option agreement against Paramount's wishes, Paramount or its shareholders might have been able to use section 193 as a defense. The provision is inapposite in the *QVC* situation, however, because neither of the parties attempted to avoid performance.

2. Whether Directors Have the Power to Contract in Violation of Their Duty of Care

As this article has discussed, the Delaware Code specifies that the board of directors has the power and authority to act on behalf of the corporation.[260] Directors may be held personally liable for damages arising out of their breach of the duty of care[261] unless the certificate of incorporation contains an exculpation provision.[262] Therefore, the

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[256] *Id.*

[257] RESTATEMENT (SECOND) OF CONTRACTS § 193 (1979).

[258] *Id.* at cmt. a.

[259] *See, e.g., In re* U.S. Lines, Inc., 103 B.R. 427 (Bankr. S.D.N.Y. 1989), *order aff'd*, Nos. 90 Civ. 3823 (MGC) & 90 Civ. 4491 (MGC), 1991 U.S. Dist. LEXIS 5262 (S.D.N.Y. Apr. 19, 1991); Tedvest Agrinomics VI v. Tedmon Properties V, 744 P.2d 648 (Wash. Ct. App. 1987).

[260] DEL. CODE ANN. tit. 8, § 141 (1991).

[261] Many of the recent high-profile corporate cases in Delaware involved claims that the directors were personally liable for damages. *See, e.g.*, Arnold v. Society for Savings Bancorp, 678 A.2d 533 (Del. 1996); Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1994); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[262] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (1991) (permitting exculpation for violation

Paramount court's holding that contracts made in violation of the directors' duty of care are invalid is unnecessary and possibly counterproductive.

First, the rule is unnecessary because the shareholders have another remedy. They may disapprove a proposed merger that they do not favor and, even if the requisite number of shareholders votes to approve the transaction, they may sue the directors alleging breach of fiduciary duty. If there is a concern that the directors will not be able to satisfy a damage award, then the corporation should purchase insurance to cover potential liability.

Second, the rule is confusing, because both statutory and case law clearly give the board of directors the authority and power to cause the corporation to enter into contracts.[263] The Delaware Supreme Court lacks the authority to rewrite or eviscerate the statutory grant of authority to directors.

Third, the rule is unnecessary, because if the contract is determined to be unconscionable or against public policy, its performance can be enjoined at equity. If the contract is not unconscionable or against public policy, there are strong policy arguments in favor of upholding it.

Negotiating and contracting behavior imposes costs on the parties. To the extent that enforceability of a contract is tinged with doubt, contracting parties will demand compensation for the risk that their contracted-for benefits will not be enforceable, driving up the costs of entering into the contract, and thus lowering the value of the contract.

It makes sense to distinguish between breach of care and breach of loyalty or good faith. Generally, it will be apparent both to a board of directors and to its contracting partners if negotiations present an opportunity for self-dealing or a temptation to contract for personal benefit rather than corporate/shareholder benefit.[264] Similarly, directors will know when they are not acting in good faith. To the contrary, however, the *Paramount* facts make it very clear that a board of directors may inadvertently and unknowingly breach their duty of care while believing that they are acting in the best interests of the corporation. Therefore, the possibility that a court may later invalidate the directors' actions is less likely to act as a deterrent to a breach of care than it is to

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of the duty of care, but not for the duty of good faith or the duty of loyalty). *See supra* text Part III.A.2 for a discussion of this provision.

[263]DEL. CODE ANN. tit. 8, § 141 (1991).

[264]*Revlon* may be an exception to this knowledge rule, since the breach of loyalty to the shareholders was not to benefit the directors; it was to benefit Revlon's noteholders. It is not clear that the Revlon directors had any intent to breach their duty of loyalty to the shareholders. *See Revlon*, 506 A.2d at 182.

a breach of loyalty or good faith, because the *Paramount* case demonstrates that directors may have difficulty determining exactly what is required of them. If directors do change their behavior in response to the *Paramount* decision, they might easily take (or their contracting partners might require them to take) too much care — that is, needless and expensive precautionary measures to attempt to comply with their duty of care, even if the expense does not benefit the shareholders.[265] As long as the directors have facial authority to enter into a contract (which would exclude illegal contracts, for instance), and as long as their actions do not violate their duties of loyalty or good faith, they should have the power to cause the corporation to enter into binding agreements. If shareholders can later prove that the directors' actions were in violation of their fiduciary duty of care, the remedy should be monetary damages against the directors or their insurance company.

C. *Standard of Scrutiny*

1. Business Judgment Rule

Scrutiny of most business decisions made by corporate boards of directors is governed by the business judgment rule. This rule is a

> presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. . . . The burden is on the party challenging the decision to establish facts rebutting the presumption.[266]

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[265]In the wake of *Van Gorkom*, many commentators concluded that, in takeover or change of control transactions, boards of directors would be forced to procure expensive fairness opinions from investment banking firms to prove that their internal valuation of the company was validated by an external, supposedly neutral authority. These fairness opinions would be sought even when they were unnecessary in the business judgment of the board in order to forestall any potential claim that they had acted without due care, and were thus subject to personal liability.

Similarly, in *Paramount*, the court insists that it is not requiring that particular measures be taken (although it suggests that canvassing the market and actually auctioning the company are possibilities). *Paramount*, 637 A.2d at 44. However, the effect of the decision is to compel directors to take precautions which may or may not provide benefit commensurate with their cost in order to avoid personal liability.

[266]*Aronson*, 473 A.2d at 812 (citations omitted).

Shareholders are understandably inclined to judge the performance of directors by results, rather than by whether a decision was reasonable when it was made.[267] The rule is intended to protect the discretion of directors to manage the corporation and to permit them to act without fear that their decisions are subject to second guessing by the shareholders.[268] Thus, even if a directorial decision can be shown in hindsight to be misguided or unwise, the directors are not personally liable for such mistakes of judgment. The rule does not apply when the directorial decision is tainted by a conflict of interest or other question as to director loyalty.[269]

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[267]*See* Joy v. North, 692 F.2d 880 (2d Cir. 1982), *cert. denied sub nom.*, Citytrust v. Joy, 460 U.S. 1051 (1983):

> [L]iability is rarely imposed upon corporate directors . . . simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labelled the business judgment rule . . . .
> Whatever its merit, however, the business judgment rule extends only as far as the reasons which justify its existence. Thus it does not apply in cases, *e.g.*, in which the corporate decision lacks a business purpose, is tainted by a conflict of interest, is so egregious as to amount to a no-win decision, or results from an obvious and prolonged failure to exercise oversight or supervision.

Id. at 885-86 (citations omitted).

[268]*See, e.g.*, Kamin v. American Express Co., 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976), *aff'd*, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976).

> A complaint which alleges merely that some course of action other than that pursued by the Board of Directors would have been more advantageous gives rise to no cognizable cause of action. Courts have more than enough to do in adjudicating legal rights and devising remedies for wrongs. The directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions . . . .

Id. at 810-11.

[269]*See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

> A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. [However,] . . . [w]hen the situation involves a parent and a subsidiary, with the parent controlling the transaction and fixing the terms, the test of intrinsic fairness, with its resulting shifting of the burden of proof, is applied.

Id. at 720. See also United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917), in which Justice Brandeis commented that a corporate board's decision not to bring a lawsuit

> is, like other business questions, ordinarily a matter of internal management, and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. Courts interfere seldom to control such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment.

2. Heightened Scrutiny in Change of Control Situations

The Delaware Supreme Court has held that "the business judgment rule, including the standards by which director conduct is judged, is applicable in the context of a takeover."[270] In *Unocal*, the court said that a board's obligation to consider whether a takeover offer is in the shareholders' best interests "is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment."[271] However, the court continued, resisting a takeover was not precisely business as usual: "Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."[272]

This judicial examination requires directors to prove that they acted in good faith and after reasonable investigation.[273] The *Unocal* court found that proof of good faith and reasonable investigation is "materially enhanced" by showing that the majority of the directors who made the decision to resist a takeover attempt were "outside independent directors who have acted in accordance with the foregoing standards."[274]

The Delaware Supreme Court proposed a similar enhanced scrutiny test in *Paramount*. The court said that the test it employed has two key features:

> (a) a judicial determination regarding the adequacy of the decisionmaking process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.[275]

Id. at 263-64.

[270]Pogostin v. Rice, 480 A.2d 619, 627 (Del. 1984), *cited in Unocal*, 493 A.2d at 954.

[271]*Unocal*, 493 A.2d at 954.

[272]*Id.*

[273]*Id.* at 955. The court noted that "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. However, they satisfy that burden 'by showing good faith and reasonable investigation . . . .'" *Id.* (citations omitted).

[274]*Id.*

[275]*Paramount*, 637 A.2d at 45.

Eleven of Paramount's fifteen directors were independent, that is, they were not officers of the company.[276] The court acknowledged that Paramount's board had strongly favored Viacom as a merger partner, and that it had been unreceptive to the possibility of alternative transactions.[277] But the court found that

> the reasons for that partiality are not venal but laudatory. The independent directors have no demonstrated self-interest in the transaction, or in perpetuating Mr. Davis or themselves in office. What drives their conduct is a fervently and honestly-held view that the Viacom deal is the *only* valuable transaction that will serve the best interests of Paramount and its shareholders.[278]

The *Unocal* court acknowledged that the reason for heightened scrutiny in takeover cases was the danger of conflict of interest.[279] If there is no breach of loyalty, is heightened scrutiny appropriate? Since the chancery court specifically said that loyalty was not at issue in *QVC*, should the Paramount directors have been entitled to the protection of the business judgment rule?

Oddly, neither the scrutiny imposed in *Unocal* nor that imposed in *Paramount* focuses on whether there was in fact a breach of the duty of loyalty due to a conflict of interest, or even whether there was likely to be a conflict. Instead, courts following these cases are directed to focus their heightened scrutiny on the other fiduciary duties, i.e., the duty of care and the duty of good faith.[280] If the directors can show that they complied with those obligations, then the court does not scrutinize their loyalty; that is presumed, and they receive the benefit of the business judgment rule.[281]

If the reason for heightened scrutiny in change of control situations is the danger of conflict of interest, it should be applied differently. The directors should bear only the burden of proof that their actions in connection with the change of control transaction did not breach their duty of loyalty. Once they show this, the burden should shift back to the

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[276] *QVC*, 635 A.2d at 1247.
[277] *Id.* at 1269.
[278] *Id.*
[279] *Unocal*, 493 A.2d at 954.
[280] *QVC*, 635 A.2d at 1265.
[281] *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

shareholders to prove some breach of fiduciary duty, and the directors should receive the benefit of the business judgment rule presumption.

V. CONCLUSION

The *Paramount* decision is fatally flawed. First, it is not clearly supported by either statute or precedent. It thwarts Delaware's statutory scheme, which provides power and authority to directors to manage the corporation, imposes fiduciary duties, and permits shareholders to sue for damages for violation of those duties. By invalidating the Viacom agreements, the court emasculates the board and renders the exculpation statute meaningless.

Second, it is ill-conceived from a policy standpoint, and is likely to cost shareholders more than it benefits them. It creates substantial uncertainty as to the validity of contracts, driving up the cost of contracting. It provides precedent for a party with no legal interest in a transaction to disrupt it, encouraging litigious behavior by strangers to a contract. It encourages judges to make business decisions for which they are ill-equipped and to impose those decisions on shareholders who have not elected them and cannot remove them from office.

And third, it continues to obscure rather than clarify the standard of care applicable to directors' fiduciary duties. The court's failure to articulate a comprehensible standard of care is guaranteed to cause more litigation than it prevents. This uncertainty and increased risk of litigation will make it both more expensive and more difficult to be a director of a Delaware corporation. As a result, it is likely to become increasingly difficult to find skilled and qualified people to serve on the boards of Delaware corporations.

The decision eviscerates the gross negligence standard ostensibly governing corporate directors' duty of care.[282] Although the *Paramount* court does not admit that it is changing that standard, its review of the

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[282]*See Van Gorkom*, 488 A.2d at 873.

> The standard of care applicable to a director's duty of care has also been recently restated by this Court. In *Aronson* . . . we stated:
>
> > While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.
>
> We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.

Id. (quoting *Aronson*, 473 A.2d at 812 (footnote omitted)).

Paramount directors' conduct employs a standard that in fact exceeds not only gross negligence but also reasonable care, and approaches a standard of extraordinary care.[283] The Paramount directors were conscious of *Van Gorkom* and complied with their duties as they understood them.[284] Nevertheless, the court found that, because they could have done more, they should have done more.[285] "Could have done more" is not a reasonable measure of gross negligence.

Although the court pays homage to the notion that directors have the statutory authority to manage the corporation,[286] it in fact substitutes the business judgment of the judges for that of the directors, and it does so without any evidence or even any claim that the Paramount directors had a conflict of interest or motive other than the long-term best interests of Paramount's shareholders. This is in spite of the fact that the repeatedly-cited rationale for imposing heightened scrutiny in change of control transactions is the danger of conflict of interest.[287] Even in change of control transactions, then, heightened scrutiny should be appropriate only to the extent that it permits the court to discern potential or actual conflicts of interest.

Although Delaware's corporate jurisprudence is asserted to constitute an "unbroken line" of cases,[288] Delaware corporate law now has many conflicting precedents.[289] For example, in the 1996 case of *Arnold v. Society for Savings Bancorp*,[290] the Delaware Supreme Court takes us for yet another ride on the Delaware seesaw of fiduciary obligation. In *Arnold*, unlike *Paramount*, a breach of fiduciary duty did not invalidate

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[283]*See supra* text accompanying notes 245-46.

[284]*QVC*, 635 A.2d at 1263.

[285]*Paramount*, 637 A.2d at 50.

[286]*Paramount*, 637 A.2d at 41.

[287]*See Unocal*, 493 A.2d at 954.

[288]*See Barkan*, 567 A.2d at 1286 ("Revlon is merely one of an unbroken line of cases that seek to prevent the conflicts of interest that arise in the field of mergers and acquisitions by demanding that directors act with scrupulous concern for fairness to shareholders.").

[289]The *Paramount* court's attempt to distinguish *Paramount* from *Time* and liken it to *Revlon* is unconvincing to this writer, and the consequence of evaluating the directors' conduct under *Revlon* has less than salutary effects for the shareholders. The court's insistence on the shareholders' right to receive the largest possible control premium requires directors to shift their focus from the long term to the short term whenever a transaction involves a change of control. Even though the Paramount directors negotiated for a premium over the market price, their efforts to create long-term value for the shareholders and to act in the best interest of the corporation was deemed by the *Paramount* court to violate their duty to get the highest current price. This provides no incentive for directors to seek out or create transactions that they believe will have *long-term* benefits, because as soon as they have created such a transaction, *Paramount* says that they must try to torpedo it by seeking a higher immediate price.

[290]678 A.2d 533 (Del. 1996); *see supra* text accompanying note 100.

a merger transaction.[291] Why? Because that "would create uncertainty for third parties dealing with Delaware corporations."[292] Although *Arnold* involved a completed merger, and outsiders are undoubtedly more likely to rely on the finality of a completed merger than the validity of a executory contract, the difference is one of degree, not of kind. Therefore, the same policy rationale should apply to *Paramount*. As a result of the court's failure to establish a consistent standard, corporate directors are likely to find compliance with the moving target of fiduciary duties either impossible, prohibitively expensive, or unwise from a business perspective.

The Paramount directors apparently would have satisfied the court if they had sold the company to the highest bidder, but they genuinely believed after substantial investigation that the Viacom combination would provide the most synergy and long-term value for their shareholders.[293] Although the *Time* court indicated that boards could and should craft long-term business strategies[294] and that the court would protect them when those plans came under outside attack,[295] the *Paramount* court instead second-guessed the directors' business judgment.[296] The negotiated merger with Viacom was dissimilar to the

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[291]*Arnold*, 678 A.2d at 541-42 & n.21.

[292]*Id.* at 537.

[293]*Paramount*, 637 A.2d at 41.

[294]*Time*, 571 A.2d at 1150.

> Delaware law imposes on a board of directors the duty to manage the business and affairs of the corporation. This broad mandate includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of "long-term" versus "short-term" values is largely irrelevant because directors, generally, are obliged to chart a course for a corporation which is in its best interests without regard to a fixed investment horizon. Second, absent a limited set of circumstances as defined under *Revlon*, a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover.

Id.

[295]*Id.* at 1152. "We have repeatedly stated that the refusal to entertain an offer may comport with a valid exercise of a board's business judgment." *Id.* "[T]he Time board's . . . investigation of potential merger candidates, including Paramount, mooted any obligation on Time's part to halt its merger process with Warner to reconsider Paramount. Time's board was under no obligation to negotiate with Paramount." *Id.* at 1154.

[296]Cf. the *Time* court's discussion of the appropriate application of *Unocal* heightened scrutiny:

> Plaintiffs' position . . . would involve the court in substituting its judgment as to what is a "better" deal for that of a corporation's board of directors. To the extent that the Court of Chancery has recently done so in certain of its

corporate break-up of Revlon. However, because the court found that a change of control would occur as a result of the Viacom merger, it imposed *Revlon* auction duties, completely discounting the Paramount board's careful planning for the future of the company.[297] To protect the Viacom deal from the court's meddling, the Paramount board apparently would have needed to engage in costly and time-consuming strategies such as conducting an auction or canvassing the market.[298] The decision thus encourages the waste of corporate assets to support conclusions reached by skillful and loyal managers and their expert advisors after they have evaluated various potential courses of action.

In sum, there is little to praise about the *Paramount* decision and a great deal to worry about. No one wants the law to permit or encourage directors to breach their fiduciary duties or behave in ways that harm the shareholders. But if directors are to use their business skills to create value for their shareholders and long-term profitability for their corporations, courts must defer to their business judgments unless there is clear proof of gross negligence, bad faith, or breach of loyalty.

> opinions, we hereby reject such approach as not in keeping with a proper Unocal analysis.

Time, 571 A.2d at 1153.

[297] *Paramount*, 637 A.2d at 47-48.

[298] *See supra* note 88.