REVLON AND *HANSON TRUST*: UNLOCKING THE LOCK-UPS

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In noteworthy decisions, the Delaware Supreme Court and the Second Circuit Court of Appeals (applying New York law) recently have enjoined actions taken by boards of directors to "lockup" white-knight acquisition proposals in the face of active bidding contests for control. The decisions reaffirm that "lock-ups" are not per se illegal. Nevertheless, both decisions create significant uncertainty about the use of "lock-ups" in many situations in which they have been employed. In broader terms, these opinions appear to recognize a more stringent duty on the part of directors to secure the highest available price when selling the corporation or its control. These decisions focus upon two recurrent issues: (1) what are a director's obligations in considering a lock-up in the context of a sale of corporate control?, and (2) what must the board do to ensure that its decisions withstand later scrutiny?

I. INTRODUCTION

This article first reviews the applicability of fiduciary duty principles in the context of hostile takeovers and the individual areas of inquiry undertaken by courts in reviewing actions taken by directors in contests for corporate control. It then considers the early decisions concerning lock-ups. This discussion is followed by a review of the Delaware Supreme Court's decision in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[1] and the Second Circuit Court of Appeals' decision in *Hanson Trust PLC v. ML SCM Acquisition, Inc.*.[2] These decisions apply long-standing state law[3] principles to unique factual

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1. 506 A.2d 173 (Del. 1986).

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

3. It is now clear that federal law plays no role in the regulation of lock-ups assuming adequate disclosure and the absence of inherent deception. That has not always been the case. After Mobil Corp. v. Marathon Oil Co., the role of federal law in regulating lock-ups was unclear. *See* Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981), *cert. denied*, 455 U.S. 982 (1982). In *Mobil*, the

situations involving lock-ups.[4]

The article then considers various factors examined by courts reviewing director approval of a lock-up to a favored bidder. In the course of analysis, this article reviews the circumstances under which director consideration of constituencies other than stockholders may be appropriate.

II. SETTING *REVLON* AND *HANSON TRUST* IN CONTEXT

A. *Fiduciary Duties of Directors in the Takeover Context*

The stockholders own the corporation[5] and have the rights of franchise and alienation with respect to shares owned by them.[6] The

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court set aside lock-up options granted to a white knight on the ground that the options constituted "manipulative acts" under § 14(e) of the Securities Exchange Act of 1934 because they "artificially and significantly" discourage competing bids and "circumvent the natural forces of market demand in a tender offer contest." *Id.* at 376. The Supreme Court effectively overruled *Mobil* in Schreiber v. Burlington N., Inc., 472 U.S. 1 (1985), although the *Schreiber* case did not involve a lock-up. The Supreme Court found that (1) the purpose of § 14(e) is to ensure that public stockholders who are confronted with a tender offer will not be required to respond without adequate information and (2) § 14(e) is a disclosure statute which was not designed to govern the substantive fairness of tender offers. *Id.* at 8-11. After *Schreiber*, it is clear that the granting by corporate directors of lock-ups which appear to be unfair to stockholders, so long as they are fully disclosed and not inherently deceptive, is an issue of the relevant state law which governs the acts of corporate fiduciaries.

4. An asset lock-up option involves "making some [corporate] assets available to the potential buyer at a price less than those assets would bring in an ordinary sale, thereby tending to foreclose further bidding for the target company." *Hanson*, 781 F.2d at 284 (Oakes, J., concurring). Most lock-ups are employed in a "defensive" manner to facilitate the intervention and success of a white knight. However, potential acquirors can also use a lock-up in an "offensive" manner by negotiating agreements with the target or its stockholders to help ensure the success of the takeover bid. *See* EAC Indus., v. Frantz Mfg. Co., No. 8003 (Del. Ch. June 28, 1985), *reprinted in* 11 DEL. J. CORP. L. 608 (1986), *aff'd*, 501 A.2d 401 (Del. 1985); Repairman's Serv. Corp. v. National Intergroup, Inc., No. 7811 (Del. Ch. Mar. 15, 1985), *reprinted in* 10 DEL. J. CORP. L. 902 (1985); Thompson v. Enstar Corp., Nos. 7641, 7643 (Del. Ch. June 20, 1984), *reprinted in* 9 DEL. J. CORP. L. 822 (1984), *revised* Aug. 16, 1984.

5. *See* Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 254 (7th Cir. 1986) *rev'd*, 107 S. Ct. 1637 (1987) ("It is supposed to be the shareholders' company, for it is they who are entitled to all the income that the company generates after paying off all contractually or otherwise obligated expenses.").

6. *See* Conoco, Inc. v. Seagram Co., 517 F. Supp. 1299, 1303 (S.D.N.Y. 1981). The court stated:

> What is sometimes lost sight of in these tender offer controversies is that the shareholders, not the directors, have the right of franchise with respect to the shares owned by them; "stockholders, once informed of the facts,

directors are fiduciaries entrusted with the management of the business and affairs of the corporation.[7] These facts have been reemphasized by courts in considering director conduct alleged to have been improperly motivated.[8] In *Norlin Corp. v. Rooney, Pace, Inc.*,[9] the Second Circuit enjoined director action designed to deter a feared hostile acquisition attempt,[10] stating:

> Our most important duty is to protect the fundamental structure of corporate governance. While the day-to-day affairs of a company are to be managed by its officers under the supervision of directors, decisions affecting a corporation's ultimate destiny are for the shareholders to make in accordance with democratic procedures.[11]

As the Delaware Supreme Court again made clear in *Unocal Corp. v. Mesa Petroleum Co.*,[12] directors owe fiduciary duties to stockholders in the context of proposed transactions involving sale of control. Indeed, the fiduciary duties of care and loyalty "are the bedrock of [Delaware] law regarding corporate takeover issues."[13]

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have a right to make their own decisions in matters pertaining to their economic self-interest, whether consonant with or contrary to the advice of others, whether such advice is tendered by management or outsiders or those motivated by self-interest."

7. DEL. CODE ANN. tit. 8, § 141 (1983), *amended by* 65 Del. Laws c. 127, § 3 (1986). *See also* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others.").

8. Courts have shown an increasing willingness to enjoin actions taken by directors to deter a hostile acquisition. *See* Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986); Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250 (7th Cir. 1986) *rev'd*, 107 S. Ct. 1637 (1987); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255 (2d Cir. 1984); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

9. 744 F.2d 255 (2d Cir. 1984).

10. In *Norlin*, the court enjoined Norlin Corporation from voting new common and voting preferred stock issued to a wholly-owned subsidiary and a newly created employee stock option plan. Since Norlin planned to control the voting of the newly-issued stock, the effect of the transaction was to concentrate greater voting control in the hands of its board of directors and thus to ward off any acquisition attempts that might be made against the company. *Id.* at 258.

11. *Id.*

12. 493 A.2d 946, 953, 955 (Del. 1985). *See also* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1350 (Del. 1985); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984).

13. *Revlon*, 506 A.2d at 179. For a comprehensive discussion of the duty of care under Delaware law, see Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

As fiduciaries, directors who conclude that a sale of the corporation is necessary or in the stockholders' best interests must seek the best price available for the corporation's assets.[14] If, however, the board, after due deliberation, determines that stockholder interests are best served by opposing a particular unfair acquisition proposal, the directors are obligated to take steps to thwart the proposal and the proposed acquiror.[15] Decisions under Delaware law have condoned a variety of actions designed to deter a hostile acquiror, including the sale for a fair price of a substantial asset coveted by the acquiror, and a selective stock buyback designed to exclude the proposed acquiror.[16]

Delaware law also recognizes the power of directors to erect "structural" defenses as an aid to their ability to negotiate on behalf

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See also Gimbel v. Signal Cos., 316 A.2d 599, 615 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974) (enjoining a proposed sale of assets after finding that the "hasty method" employed by the directors to approve the transaction produced "a dollar result which appears perhaps to be shocking"). For a comprehensive discussion of the duty of loyalty under Delaware law, *see* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

14. *See* Thomas v. Kempner, No. 4138, slip op. at 12 (Del. Ch. Mar. 22, 1973) (enjoining a proposed sale of assets where the directors dealt with only one potential buyer even "after it was readily apparent that at least one other group was not only interested in acquiring the [asset] in issue but was willing to top [the prior] offer as to cash"). *See also* Lockwood v. OFB Corp., 305 A.2d 636, 639 (Del. Ch. 1973) (directors undertaking to sell assets have a duty to engage in "a reasonably aggressive program which [men] of prudence, discretion and intelligence would have followed in an effort to sell their own property"); Robinson v. Pittsburgh Oil Ref. Corp., 126 A. 46, 49 (Del. Ch. 1924) (directors selling corporation's assets at direction of stockholders presumed to act bona fide for best interests of the corporation). *Compare* Abelow v. Midstates Oil Corp.,189 A.2d 675, 678-79 (Del. 1963) (rejecting as "pure speculation" the argument that the directors "should have solicited other offers, which might have been higher" in undertaking to sell the corporation's assets); Simkins Indus. v. Fibreboard Corp., No. 5369, slip op. at 2 (Del. Ch. July 28, 1977) (rejecting plaintiff's contention "that defendant be required by this Court to conduct its proposed sales of its carton producing assets as if defendant were a government agency, namely on the basis of sealed bids or by Court regulated competitive bidding"); Bowling v. Bonneville, Ltd., No. 1688, slip op. at 7 (Del. Ch. Jan. 14, 1963) (the directors' "duty to obtain the best offer . . . does not require that the assets be placed upon the auction block").

15. *See Unocal*, 493 A.2d at 954 ("a board of directors is not a passive instrumentality"); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 114 (Del. 1986), ("A board need not be passive . . . .").

16. Whittaker Corp. v. Edgar, 535 F. Supp. 933, 949 (N.D. Ill. 1982) (target sold a subsidiary to a third party at a price exceeding the tender offeror's valuation of the same subsidiary). *See also Unocal*, 493 A.2d 946 (selective stock buy-back); GM Sub Corp. v. Liggett Group, Inc., No. 6155, slip. op. at 4 (Del. Ch. Apr. 25, 1980) (Liggett, the target, sold a subsidiary to the highest of nine bidders at a price "very favorable to Liggett.").

of stockholders with a potential acquiror. In *Moran v. Household International, Inc.*,[17] the Delaware Supreme Court confirmed that directors could adopt a "Preferred Stock Rights Plan" designed to deter acquisitions not approved by the board. By requiring an acquiror to sell its stock to the stockholders of the target for one-half its market value, the Household Rights Plan deters unwanted acquisitions by making them prohibitively expensive.[18] While the Delaware Supreme Court upheld the decision of the directors of Household to adopt the Rights Plan, the court noted that the board nevertheless had fiduciary duties and fidelity to those duties could be subject to later review in the context of the board's response to a specific takeover threat.[19] *Household* may represent an extension of director power; however, that increased power[20] may have come at a price that was not fully realized before the decisions in *Revlon* and *Hanson Trust*. Greater power to affect the property interests of stockholders necessarily implies greater responsibilities and higher expectations.[21] If a board assumes such greater power by adopting a rights plan[22] or by otherwise acting to influence the result of a battle for corporate control (such as by granting a lock-up), it must be prepared to meet the higher expectations the courts may imply.[23]

B. *Lock-Up Decisions Prior to* Revlon *and* Hanson Trust

Lock-ups are inherently contradictory actions. They may be justified as necessary to secure a superior bid, even though they may serve to discourage a competing bidder from making an even higher offer.[24] At a minimum a lock-up gives a favored bidder a "leg-up" in its acquisition effort. When more extreme, a lock-up will make it difficult or impossible for another bidder to compete. Courts have

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17. 500 A.2d 1346 (Del. 1985).

18. Moran v. Household Int'l, Inc., 490 A.2d 1059, 1077 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

19. *Household*, 500 A.2d at 1357.

20. The Delaware Court of Chancery found that Household had "increase[d] its bargaining powers in tender offers" and "assumed a plenary negotiating role." *Household*, 490 A.2d at 1074, 1080, *aff'd*, 500 A.2d 1346 (Del. 1985).

21. *See* Chittur, *Wall Street's Teddy Bear: The "Poison Pill" as a Takeover Defense*, 1985 J. CORP. L. 25, 43 (1985).

22. MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1247 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986).

23. *See* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986).

24. *See Hanson*, 781 F.2d at 282; *Revlon*, 501 A.2d at 1250.

reacted differently to lock-ups depending on the impact of the various devices on competition and the circumstances surrounding their use. In all cases, however, lock-ups have received careful judicial scrutiny.

Before *Revlon*, the only Delaware decision to consider a challenge to the validity of a lock-up transaction was *Thompson v. Enstar Corp.*[25] In *Enstar*, the court of chancery considered the decision of the directors of Enstar to create a voting trust giving Unimar voting control over Enstar's interest in an Indonesian joint venture—Enstar's "single most valuable asset."[26] The lock-up, which was granted while a proxy contest for control of the Enstar board was pending,[27] was supported by no consideration other than Unimar's entry into an agreement to make a tender offer for Enstar.[28] The court found the lock-up "troublesome," in part because the Enstar board had been advised at the time it considered the Unimar bid that another entity might make a higher bid.[29]

In upholding the decision of the Enstar directors to grant the lock-up, the court applied a more stringent standard of review than that employed under the typical business judgment rule analysis:

> Lock-up agreements have been justifiably criticized. They often prevent open bidding for assets. . . . They also often infringe on the voting rights of shareholders. They therefore must be given careful scrutiny by a court to see if under

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25. Nos. 7641, 7643 (Del. Ch. June 20, 1984), *reprinted in* 9 DEL. J. CORP. L. 822 (1984), *revised* Aug. 16, 1984.

26. *Id.* at 8-11, *reprinted in* 9 DEL. J. CORP. L. at 828-30.

27. *Id.* at 2, *reprinted in* 9 DEL. J. CORP. L. at 825. Plaintiff Roy M. Huffington, the holder of the largest block of Enstar stock, had commenced a proxy contest seeking to elect his slate of directors at Enstar's annual meeting on June 21, 1984. *Id.* The court found that the seated directors commenced "some-what frantic" efforts to sell the assets of Enstar in response to the perception that Huffington would win the proxy contest. *Id.* at 3, *reprinted in* 9 DEL. J. CORP. L. at 825. While all parties agreed that the assets of Enstar should be sold, the Huffington plaintiffs desired that the sale be postponed until after the annual meeting when, presumably, they would be in control. *Id.*

28. *Id.* at 10, *reprinted in* 9 DEL. J. CORP. L. at 829.

29. *Id.*, *reprinted in* 9 DEL. J. CORP. L. at 830. While there "was not a competing bid as such," there was an indication by a group headed by Tesoro Corporation of an interest in acquiring Enstar. Tesoro had been contacted previously but had indicated no interest. After it began to show some interest, it did not respond promptly to overtures from Enstar's investment banker. By May 22, 1984, the date of the Enstar board's decision, Tesoro's proposal was indefinite as to material terms. Tesoro indicated it would take another three to five days to work up a firm proposal. *Id.* at 9, *reprinted in* 9 DEL. J. CORP. L. at 829.

> all the facts and circumstances existing in a particular case they are fair to the shareholders.
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> . . . .
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> The test of whether a lock-up provision should be upheld is whether management acted reasonably . . . .
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> While it is a close call, I find from all the facts and circumstances, that the plaintiffs have not sustained their burden of showing a reasonable probability that the approval of the lock-up agreements is not fair to the shareholders or that the directors acted unreasonably in adopting them.[30]

The court found that the Enstar board had acted "reasonably" in granting the lock-up in view of the facts that "sufficiently adequate efforts to seek other offers" had been made, no other offers had resulted[31] and the proposed acquiror had threatened to withdraw its offer if it were not accepted immediately.[32]

In *Buffalo Forge Co. v. Ogden Corp.*,[33] the Second Circuit applied New York law in upholding the decision of the directors of Buffalo Forge to sell treasury shares and grant a stock option to Ogden, a white knight, in order to deter an inadequate tender offer by Ampco.[34] Ogden specified that the stock sale and lock-up option were indispensable preconditions to its willingness to make a merger proposal.[35]

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30. *Id.* at 13, *reprinted in* 9 DEL. J. CORP. L. at 831.

31. *Id.* An extensive search for potential buyers of Enstar had resulted in contact with over 100 prospects and in-depth review of Enstar by 26 seriously interested potential buyers. *Id.* at 8, *reprinted in* 9 DEL. J. CORP. L. at 832. Despite the search, only one firm offer was before the board on May 22, 1984 when it granted the lock-up. *Id.*

32. *Id.* at 12-13, *reprinted in* 9 DEL. J. CORP. L. at 831. The court found that the directors had acted reasonably in concluding that Unimar's offer was the best that could be obtained under the circumstances and that it was possible that it might soon be withdrawn, thereby leaving the stockholders of Enstar to face the prospect of liquidation "for a much lesser price and at some time in the distant future." *Id.* at 13, *reprinted in* 9 DEL. J. CORP. L. at 831.

33. 717 F.2d 757 (2d Cir.), *cert. denied*, 464 U.S. 1018 (1983).

34. *Id.* at 759. In response to a tender offer of $25 per share made on January 2, 1981 by Ampco-Pittsburgh Corporation, Buffalo Forge Company began a search for more favorable offers. After negotiations, Buffalo Forge's board approved a merger proposal from Ogden Corporation, calling for an even exchange of Ogden stock, then trading at $32.75, for shares of Buffalo Forge. As part of the "Agreement and Plan of Reorganization" between the parties, the directors agreed to sell Ogden 425,000 shares of Buffalo Forge treasury stock at $32.75 per share, to be paid for by a ten-year, 9% note in the face amount of $13,918,750, and gave Ogden a one-year option to purchase an additional 143,400 treasury shares on similar terms. *Id.* at 758-59.

35. Buffalo Forge Co. v. Ogden Corp., 555 F. Supp. 892, 901 (W.D.N.Y.), *aff'd*, 717 F.2d 757 (2d Cir.), *cert. denied*, 464 U.S. 1018 (1983). The court found

However, since the stock sale and option amounted to only 20% of Buffalo Forge's voting stock, the bidding contest was not ended by Buffalo Forge's entry into the lock-up agreement.[36] Ampco, the hostile suitor, ultimately prevailed after increasing its acquisition price from $25 to $37.50 per share.[37] Ampco then sought to rescind the sale and option granted to Ogden, and refused to pay for the shares tendered by Ogden.[38]

The district court upheld the decisions of Buffalo Forge's directors stating:

> In this case, the record shows that neither Ogden nor Buffalo Forge intended the sale of the treasury shares and the grant of the option to foreclose additional bidding, either by Ampco or by third parties. And, in fact, the sale of the treasury shares did not foreclose competitive bidding, but rather stimulated it.[39]

The court of appeals affirmed and concluded that "it would have been a mistake for the district court to substitute its judgment for the business judgment of the directors . . . ."[40]

Thus, the two principal decisions reviewing lock-ups prior to *Revlon* supported the directors' decisions to grant the lock-ups. Both cases found that the lock-ups had not impeded active bidding contests.[41] The court in *Buffalo Forge* found that the lock-up had actually

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that the negotiations with Ogden were at arm's length, and the price received for the treasury stock, based on the discounted value of Ogden's note, exceeded the cost of the stock, its book value and its normal trading price. *Buffalo Forge*, 717 F.2d at 759 (citing *Buffalo Forge*, 555 F. Supp. at 904-05).

36. *Buffalo Forge*, 555 F. Supp. at 906.

37. *Buffalo Forge*, 717 F.2d at 758-59.

38. *Id.* at 759. Ampco claimed that the Ogden agreement arose from a breach of the director's fiduciary duties and was a manipulative device in violation of § 14(e) of the Williams Act.

39. *Buffalo Forge*, 555 F. Supp. at 906.

40. *Buffalo Forge*, 717 F.2d at 759. The court noted the long line of New York case law and statutes concerning the business judgment rule. *See* Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980); Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y.S.2d 920 (1979); N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1982) (duty of directors).

41. *Buffalo Forge*, 555 F. Supp. at 906; *Enstar*, Nos. 7641, 7643, at 8-12, *reprinted in* 9 DEL. J. CORP. L. at 828-30. A New York state court reached a similar conclusion in Data Probe, Inc. v. CRC Information Syss., Inc., No. 92133-1983 (N.Y. Sup. Ct. Dec. 11, 1984), an action addressing the validity of a lock-up option granted by the directors of Datatab to CRC during a contest between CRC and Data Probe for control of Datatab. The option authorized CRC to purchase an

stimulated the bidding contest.[42] Moreover, the lock-up Buffalo Forge gave to Ogden did not "lock-up" a deal because Ampco ultimately outbid Ogden and acquired Buffalo Forge.[43]

The factual backgrounds in *Revlon* and *Hanson Trust* permitted no such findings. Not only did the lock-ups attempt to end active bidding contests,[44] but neither Pantry Pride nor Hanson Trust were permitted to negotiate with the board or its advisors or were informed that the bidding process was near its conclusion.[45]

III. *REVLON* AND *HANSON TRUST*

A. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.

Pantry Pride's attempt to gain control of Revlon began in June 1985 when Ronald O. Perelman, Pantry Pride's chairman, met with his counterpart at Revlon, Michel C. Bergerac, to discuss a friendly acquisition of Revlon by Pantry Pride.[46] That and all subsequent overtures were rebuffed by Mr. Bergerac.[47]

On August 19, the Revlon board met to consider the impending threat of a hostile bid by Pantry Pride.[48] After hearing presentations

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amount of Datatab's authorized but unissued voting shares equal to 200% of the company's then outstanding voting shares. Data Probe had offered a higher price for Datatab than CRC. The New York court held that the lock-up was granted by Datatab's board in order to freeze the bidding at an artificially low level and not to maximize stockholder welfare. The court found that the business judgment rule is a shield for the action of a target's directors only when they are disinterested and independent. It seemed particularly concerned that: (i) the option itself was sufficiently large that CRC would effectively have control regardless of the outcome of its tender offer for Datatab (or any other tender offer); (ii) the directors of Datatab were given lucrative employment contracts; (iii) when informed by counsel that the lock-up could be deemed excessive, the Datatab directors insisted upon and received an agreement from CRC to provide for indemnification; and (iv) the board did not demonstrate that in granting the option it was acting in the best interests of stockholders. Focusing mainly on the employment contracts and the indemnification provisions, the court held that the actions of the Datatab board were "self directed and marked by zealous devotion to their private interests."

42. *Buffalo Forge*, 555 F. Supp. at 906.

43. *Buffalo Forge*, 717 F.2d at 758-59.

44. *Hanson*, 781 F.2d at 281-83; *Revlon*, 506 A.2d at 183.

45. *Hanson*, 781 F.2d at 269-71; *Revlon*, 506 A.2d at 184.

46. *Revlon*, 506 A.2d at 176.

47. *Id.* On August 14, Pantry Pride's board authorized Perelman to acquire Revlon, either through negotiations in the $42 to $43 per share range or by making a hostile tender offer at $45. Perelman met with Bergerac and outlined Pantry Pride's alternate approaches, each of which was rejected. *Id.*

48. *Id.*

from Lazard Freres & Co., Revlon's investment banker, and the company's special counsel, the board unanimously adopted two defensive measures designed to deter Pantry Pride.[49] The company agreed to repurchase up to 5 million of its nearly 30 million outstanding shares and adopted a "Note Purchase Rights Plan."[50]

Pantry Pride made its first openly hostile move on August 23 with the announcement of a tender offer for any and all shares of Revlon at $47.50 per common share and $26.67 per preferred share, subject to (1) Pantry Pride obtaining financing for the purchase and (2) the Rights being redeemed, rescinded or voided.[51]

The Revlon board met again on August 26. The directors advised the stockholders to reject the Pantry Pride offer.[52] The board also planned further defensive measures. On August 29, Revlon commenced its own offer to purchase up to 10 million shares, exchanging for each share of common stock tendered one Senior Subordinated Note (the "Notes") of $47.50 principal at 11.75% interest, due in 1995 and one-tenth of a share of $9.00 Cumulative Convertible Exchangeable Preferred Stock valued at $100 per share.[53] The indenture governing the Notes contained a number of "poison pill" covenants which threatened to make Revlon unmanageable by Pantry Pride.[54] Lazard Freres opined that the Notes would trade at their face value on a fully distributed basis.[55]

Pantry Pride then announced a new tender offer on September 16 at $42 per share, conditioned upon receiving at least 90% of the outstanding stock.[56] At their regularly scheduled board meeting on

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49. *Id.* at 177.

50. *Id.* Under the Rights Plan each Revlon shareholder would receive as a dividend one Note Purchase Right (Rights) for each share of common stock, with the Rights entitling the holder to exchange one common share for a $65 principal Revlon note at 12% interest with a one-year maturity. The Rights would become effective whenever anyone acquired beneficial ownership of 20% or more of Revlon shares, unless the purchaser acquired all of the company's stock for cash at $65 or more per share. *Id.*

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.* Such covenants would hinder Revlon's ability to incur additional debt, sell assets, or pay dividends unless otherwise approved by the "independent" members of the board. *Id.*

55. *Id.*

56. *Id.* While this offer was lower on its face than the prior $47.50 offer, Revlon's investment banker described the two bids as essentially equal in view of the completed exchange offer. *Id.* Pantry Pride also indicated that it would consider buying less than 90%, and at an increased price, if Revlon removed the impeding Rights. *Id.*

September 24, the Revlon directors rejected the latest Pantry Pride offer and authorized management to negotiate with other parties interested in acquiring Revlon.[57] Pantry Pride raised its offer to the Revlon board to $50 per share on September 27 and to $53 on October 1.[58]

By the beginning of October, negotiations with third parties produced another offer for the company. At the board meeting on October 3, the Revlon directors unanimously agreed to a leveraged buyout proposed by Forstmann Little and members of Revlon management. Pursuant to the agreement, each Revlon stockholder would get $56 per share in cash and Revlon would redeem the Rights and waive the Note covenants for Forstmann Little or in connection with any other offer superior to Forstmann Little's.[59] When the merger proposal and the waiver of the Note covenants were announced, the market value of the Notes began to fall.[60]

Pantry Pride countered with a new proposal on October 7, raising its offer to $56.25.[61] In response, on October 12, Forstmann Little made a new merger proposal of $57.25 per share on several conditions.[62] The principal demand was a lock-up option to purchase Revlon's Vision Care and National Health Laboratories Divisions, exercisable if another acquiror obtained 40% of Revlon shares for a total consideration of $525 million.[63] This amount was some $100-$175 million below the value ascribed to them by Lazard Freres.[64]

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57. *Id.*

58. *Id.*

59. *Id.* at 178. In connection with its offer, Forstmann Little was provided certain financial data by Revlon that was denied to Pantry Pride. *Id.*

60. *Id.* The Notes, which originally traded near par, dropped to $87.50 by October 8. *Id.* One Revlon director reported a "deluge" of telephone calls from irate noteholders and, on October 10, the *Wall Street Journal* reported threats of litigation by these creditors. *Id. See* Wall St. J., Oct. 10, 1985, at 63, col. 3.

61. *Id.* The revised offer was subject to nullification of the Rights, waiver of the Note covenants and the election of three Pantry Pride directors to the Revlon board. *Id.* On October 9, representatives of Pantry Pride, Forstmann Little and Revlon met. The court found that at that meeting, Pantry Pride informed the other parties that it would engage in fractional bidding and top any Forstmann Little offer by a slightly higher one. *Id.*

62. *Id.* In addition to the lock-up, Revlon accepted a no-shop provision and placed a $25 million cancellation fee in escrow to be released to Forstmann Little if the new agreement terminated or if another acquiror got more than 19.9% of Revlon's stock. *Id.* Forstmann Little also demanded an immediate acceptance of its offer or it would be withdrawn. *Id.* at 179.

63. *Id.* at 178.

64. *Id.*

In return for the lock-up,[65] a "no-shop" provision and a $25 million cancellation fee, Forstmann Little agreed to support the par value of the Notes by an exchange of new notes.[66] The Revlon board unanimously approved the agreement with Forstmann Little.[67] On October 18, after oral argument in the court of chancery on Pantry Pride's motion for a preliminary injunction against the lock-up and other defensive measures, Pantry Pride raised its bid to $58 per share.[68]

On October 23, the court of chancery enjoined the lock-up, no-shop and cancellation fee provisions of Revlon's agreement with Forstmann Little.[69] The trial court concluded that Revlon's directors had breached their duty of loyalty by making concessions to Forstmann Little out of concern for their liability to the holders of the Notes, rather than maximizing the sale price of the company for the stockholders' benefit.[70]

The Delaware Supreme Court affirmed the trial court's decision to enter a preliminary injunction, concluding

> that under all the circumstances the directors allowed considerations other than the maximization of shareholder profit to affect their judgment, and followed a course that ended the auction for Revlon, absent court intervention, to the ultimate detriment of its shareholders. No such defensive measure can be sustained when it represents a breach of the directors' fundamental duty of care.[71]

The court began its analysis of the lock-up by reviewing the status of lock-ups under Delaware law and the circumstances under which they may be appropriate:

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65. A "no-shop" provision requires the target company to forebear from entering into competing or inconsistent agreements until after the stockholders vote on the transaction. *See* Jewel Cos. v. Pay Less Drug Stores Northwest, Inc., 741 F.2d 1555, 1561 (9th Cir. 1984) (directors did not breach their fiduciary duties under California law by agreeing, as part of a negotiated merger agreement, to a no-shop clause).

66. *Revlon*, 506 A.2d at 178-79.

67. *Id.* at 179. The new proposal provided for no participation by Revlon's management in the merger. *Id.* at 178.

68. *Id.* at 179. The revised offer was conditioned upon nullification of the Rights, waiver of the covenants and issuance of an injunction against the asset lock-up. *Id.*

69. *Id.* at 178-79; *Revlon*, 501 A.2d at 1249.

70. *Revlon*, 506 A.2d at 179; *Revlon*, 501 A.2d at 1249-50.

71. *Revlon*, 506 A.2d at 185.

> A lock-up is not *per se* illegal under Delaware law. Its use has been approved in an earlier case. Such options can entice other bidders to enter a contest for control of the corporation, creating an auction for the company and maximizing shareholder profit. Current economic conditions in the takeover market are such that a "white knight" like Forstmann might only enter the bidding for the target company if it receives some form of compensation to cover the risks and costs involved. . . . However, while those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders' detriment.[72]

The court stated that it was inappropriate for Revlon's directors to exclude Pantry Pride from the bidding contest after they shifted their posture from defending the company against a hostile bid to recognition that Revlon would be sold. It found:

> The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. . . . The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.[73]

The directors breached their duty of care because they failed to understand fully the ramifications of their prior decision to sell the company. By agreeing to lock-up the transaction with Forstmann Little without seeking the better price they were told to expect from Pantry Pride, the directors failed to satisfy their duty of gathering all material information relevant to the board's new role as auctioneer of Revlon for the benefit of its stockholders.[74]

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72. *Id.* at 183 (citation omitted).

73. *Id.* at 182.

74. *Id.* The court found that "[s]elective dealing to fend off a hostile but determined bidder was no longer a proper objective. Instead, obtaining the highest price for the benefit of the stockholders should have been the central theme guiding director action." *Id.*

Breach of the duty of loyalty was also a substantial basis for the supreme court's invalidation of the lock-up in *Revlon*. The *Revlon* court stated that the directors' focus on supporting the value of the Notes issued by Revlon as an initial part of its anti-takeover strategy, in response to "the noteholders' ire as well as their subsequent threats of suit," was inconsistent with their "primary responsibility" to the stockholders.[75] The court then held that "when the Revlon board entered into an auction-ending lock-up agreement with Forstmann on the basis of impermissible considerations at the expense of the shareholders, the directors breached their primary duty of loyalty."[76] The supreme court noted that, while concern for various corporate constituencies is proper when addressing a takeover threat, that principle is limited by the requirement that "there are rationally related benefits accruing to the stockholders."[77]

The board's concern for the continued existence of the corporate enterprise was found to justify two other defensive measures that were taken by Revlon's board prior to its decision to sell the company—the Rights plan and a self-tender exchange offer.[78] The former, like the Household Rights Plan, "afforded a measure of protection consistent with the directors' fiduciary duty in facing a takeover threat perceived as detrimental to corporate interests," namely a "bust-up" takeover bid at an inadequate price.[79] Similarly, the court upheld the defensive exchange offer because it was based on the good faith, informed conclusion of Revlon's board that Pantry Pride's any-and-all cash offer was "grossly inadequate" and the board had "rea-

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75. *Id.* The court found director attention especially misplaced because the noteholders required no further protection since their rights were fixed by contract. *See* Wolfensohn v. Madison Fund, Inc., 253 A.2d 72 (Del. 1969) (agreement for exchange of railroad and holding company's stock); Harff v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974) (debenture holders held to terms of indenture agreement).

76. *Revlon*, 506 A.2d at 182.

77. *Id.* The *Revlon* decision has been read as creating

> a dichotomy between takeover responses designed to maintain the target company's independence, in which non-stockholder constituencies may properly be considered, and the auction alternative, in which the board's objective must be to maximize stockholder values without regard to those other constituencies. Whether the Revlon decision should be read that literally, and whether that dichotomy is workable as a practical matter or sensible as a policy matter, will undoubtedly be the subject of future litigation.

See Susman & Susman, *Litigation Intensifies on Duties of Target's Directors*, Legal Times of Wash., May 26, 1986, at 10, col. 4.

78. *Revlon*, 506 A.2d at 180-81.

79. *Id.* at 181.

sonable grounds to believe that there existed a harmful threat to the corporate enterprise."[80] Finally, the court determined that it was impermissible for the Revlon directors to approve the "no shop" clause in the face of an active bidding contest.[81]

B. Hanson Trust PLC v. ML SCM Acquisition, Inc.

In *Hanson Trust PLC v. ML SCM Acquisition Inc.*,[82] SCM sought to counter a hostile bid by Hanson Trust by favoring a competing leveraged buyout proposal advanced by SCM management and Merrill Lynch.[83] Hanson Trust then topped the Merrill Lynch bid by raising its initial $60 per share offer to $72, conditioned on SCM not entering into any lock-up agreement.[84]

Merrill Lynch responded to Hanson Trust's higher bid by offering to increase its bid to $74 per share, but only on condition that it be granted certain lock-up options.[85] While SCM refused Merrill Lynch's request for stock options amounting to 18-1/2% of SCM's stock, Merrill Lynch was granted the right to acquire SCM's

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80. *Id.* at 182. But see GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016 (S.D.N.Y. 1985), where the district judge appeared to afford independent directors broad authority to protect non-stockholder constituencies in opposing a "bust-up" offer where no bidding contest was at issue. In upholding a defensive exchange offer and other Union Carbide board actions, the court noted that "the protection of loyal employees, including managers, of the organization is not anathema in the Courthouse." *Id.* at 1019.

81. *Revlon*, 506 A.2d at 184. The court found:

> The no-shop provision, like the lock-up option, while not *per* se illegal, is impermissible under the *Unocal* standards when a board's primary duty becomes that of an auctioneer responsible for selling the company to the highest bidder. The agreement to negotiate only with Forstmann ended rather than intensified the board's involvement in the bidding contest. . . . After the directors authorized management to negotiate with other parties, Forstmann was given every negotiating advantage that Pantry Pride had been denied: cooperation from management, access to financial data, and the exclusive opportunity to present merger proposals directly to the board of directors. 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.

Id.

82. 781 F.2d 264 (2d Cir. 1986).

83. *Id.* at 267.

84. *Id.*

85. *Id.*

two most profitable businesses (Pigments and Consumer Foods) for $350 million and $80 million respectively, upon the acquisition of more than one-third of SCM's common stock by a party other than Merrill Lynch.[86] Hanson Trust moved to enjoin Merrill Lynch and SCM from taking any action in connection with the lock-up options and shortly thereafter announced a $75 cash tender offer conditioned on the withdrawal or judicial invalidation of the lock-up options.[87]

In reversing the decision of the district court, the Second Circuit placed the burden on the SCM directors to demonstrate the fairness of the lock-up agreement.[88] The court found that Hanson Trust made a *prima facie* case that the SCM directors had breached their fiduciary duties by hastily agreeing to the lock-up without making adequate inquiry into the value of the optioned assets or the likelihood that the option "trigger" would be pulled.[89] The SCM directors responded, in part, by arguing that the decision to grant the lock-up was valid because it was undertaken to induce a higher bid for the company.[90]

The court noted initially that the SCM directors had "the difficult task of justifying a lock-up option that is suspect for foreclosing bidding, . . . and for thereby impinging upon shareholder decisional rights regarding corporate governance."[91] It tested the validity of the directors' motivations by evaluating "whether the lock-up option objectively benefit[ed] shareholders"[92] and concluded that the lock-up consideration provided insufficient benefits to justify a curtailment of the bidding.[93] Violation of the directors' duty of

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86. *Id.* at 267-70.

87. *Id.* at 272.

88. *Id.*

89. *Id.*

90. *Id.* at 281.

91. *Id.* (citations omitted). *See also* Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255, 258 (2d Cir. 1984).

92. *Hanson*, 781 F.2d at 281. *See also* N.Y. BUS. CORP. § 717 (McKinney Supp. 1982) (cited by the court).

93. *Hanson*, 781 F.2d at 281-82. The court, in evaluating the benefits, stated:

> For the benefit of an offer superior to Hanson's $72 cash bid by at least one dollar and change, and which arbitrageurs would value at no more than $.75 to $1.00 higher than Hanson's $72 bid, according to [SCM's investment banker], the [SCM] board approved immediate release of a $6 million "hello again" fee, and approved management's transfer into escrow of the $9 million "break-up" fee payable upon a third party's acquisition of one-third of SCM's common stock. The Board additionally optioned 50 percent of SCM's operating income from two prime businesses at conceivably well below fair value, according to the abundant evidence before the district court.

Id.

care underlays the judicial invalidation of the lock-up in *Hanson Trust*. The Second Circuit determined that SCM's directors failed to take many of the steps indicative of carefully considered board action:

> By contrast, the SCM directors, in a three-hour late-night meeting, apparently contented themselves with their financial advisor's conclusory opinion that the option prices were "within the range of fair value," although had the directors inquired, they would have learned that Goldman Sachs had not calculated a range of fairness. There was not even a written opinion from Goldman Sachs as to the value of the two optioned businesses. . . . Moreover, the Board never asked what the top value was or why two businesses that generated half of SCM's income were being sold for one-third of the total purchase price of the company under the second LBO merger agreement, or what the company would look like if the options were exercised. . . . There was little or no discussion of how likely it was that the option "trigger" would be pulled, or who would make that decision—Merrill, the Board, or management.
>
> Also, as was noted in *Van Gorkom*, the directors can hardly substantiate their claim that Hanson's efforts created an emergency need for a hasty decision, given that Hanson would not acquire shares under the tender-offer until [seven days after the decision to grant the lock-up].[94]

IV. JUDICIAL REVIEW OF DIRECTORS' ACTIONS IN DEFENDING AGAINST A HOSTILE ACQUIROR

In *Revlon*, an injunction action brought by a spurned bidder, the court analyzed a lock-up as a defensive device and placed on the directors the initial burden of proof. The court held:

> If the business judgment rule applies, there 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." However, when a board implements anti-takeover measures there arises "the omnipresent specter that a board may be acting primarily in

94. *Hanson*, 781 F.2d at 275.

> its own interests, rather than those of the corporation and its shareholders . . . ." This potential for conflict places upon the directors the burden of proving that they had reasonable grounds for believing there was a danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation. In addition, the directors must analyze the nature of the takeover and its effect on the corporation in order to ensure balance—that the responsive action taken is reasonable in relation to the threat posed.[95]

At least in Delaware, the burden is on the directors to prove the reasonableness of anti-takeover measures (including lock-ups) taken by them when those measures are challenged and an injunction is sought against their operation.[96] In such "transactional justification"[97] cases, judicial review of director decisions differs substantially from the usual "business judgment rule" analysis.[98]

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95. *Revlon*, 506 A.2d at 180 (quoting *Aronson*, 473 A.2d at 812; *Unocal Corp.*, 493 A.2d at 954) (citations omitted)).

96. *Id.* Under New York law, however, "the initial burden of proving directors' breach of fiduciary duty rests with the plaintiff" even in the context of a hostile takeover. *Hanson*, 781 F.2d at 273. *See also* Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 702 (2d Cir. 1980) (plaintiff has initial burden of proving director's interest or bad faith); Auerbach v. Bennett, 419 N.Y.S.2d 920, 926-27, 393 N.E.2d 994, 1000-01 (N.Y. 1979) (absent evidence of bad faith or fraud, courts must respect directors' determinations).

97. *Revlon*, 506 A.2d at 180 n.10.

98. *Id.* Under the customary "business judgment rule" analysis, if the requirements of the rule are satisfied, the directors' judgment will be respected by the courts, in the absence of an abuse of discretion. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). In "transactional justification" cases, the business judgment "rule" (or "doctrine") is viewed as protecting the decision itself, not the decision makers. *See* Hinsey, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine and the Reality*, 52 GEO. WASH. L. REV. 609, 611-13 (1984) [hereinafter Hinsey]. As Hinsey states the distinction: "The business judgment *rule* shields individual directors from liability for damages stemming from decisions whereas the business judgment *doctrine* protects the decision itself." *Id.* at 611-12. The Supreme Court in *Revlon*, in commenting on Hinsey's article, noted that Delaware "decisions have not observed the distinction in such terminology . . . . Under the circumstances we do not alter our earlier practice of referring only to the business judgment rule, although in transactional justification matters such reference may be understood to embrace the concept of the doctrine." *Revlon*, 506 A.2d at 180 n.10. *See also* Polk v. Good, 507 A.2d 531, 536 (Del. 1986) (using the rule with no reference to the doctrine); *Moran*, 500 A.2d at 1356 (similar); *Unocal*, at 953-55 (similar); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 943 (Del. 1985) (similar).

Traditionally, the business judgment rule has been applied to shield directors "with no financial interest in the transaction adverse to the corporation"[99] and who follow "an appropriately deliberative process"[100] from personal liability for damages to the corporation arising out of an action taken by the board.[101] If the business judgment rule applies, there 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."[102] A plaintiff then has the burden of going forward with the evidence *and* the ultimate burden of proof.[103] In a damage action,[104] these burdens apparently remain with the

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99. *AC Acquisitions Corp.*, 591 A.2d at 111.

100. *Id.* The court recognized

> that some cases acknowledge a possibility—perhaps more theoretical than real—that a decision by disinterested directors following a deliberative process may still be the basis for liability if such decision cannot be "attributed to any rational business purpose," *Sinclair Oil Corp. v. Levien*, Del. Supr., 280 A.2d 717, 720 (1971), or is 'egregious' *Aronson v. Lewis*, [473 A.2d] at 805.

AC Acquisitions Corp., 519 A.2d at 111 n.9.

101. Directors will not be held liable for honest mistakes of judgment—Perrine v. Pennroad Corp., 47 A.2d 479, 487 (Del. 1976), *cert. denied*, 329 U.S. 808 (1947); Bodell v. General Gas & Elec. Corp., 140 A. 264, 267 (Del. 1927); Karasik v. Pacific Eastern Corp., 180 A. 604, 607 (Del. Ch. 1935); if they acted with due care—Gimbel v. Signal Cos., 316 A.2d 599, 609 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974); Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971); Mitchell v. Highland-Western Glass Co., 167 A. 831, 833 (Del. Ch. 1933); in good faith—*Gimbel*, 316 A.2d at 609; Cole v. National Cash Credit Ass'n, 156 A. 183, 188 (Del. Ch. 1931); Robinson v. Pittsburgh Oil Ref. Corp., 126 A. 46, 48 (Del. Ch. 1924); Butler v. New Keystone Copper Co., 93 A. 380, 382 (Del. Ch. 1915); without a disabling conflict—Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939); Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am., 120 A. 486, 491 (Del. Ch. 1923); and in furtherance of a rational business purpose—Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); *Bodell*, 140 A. at 267.

102. *Aronson*, 473 A.2d at 812. *See also Kaplan*, 284 A.2d at 124 (directors' acts presumptively taken in good faith for the best interests of the corporation); *Robinson*, 126 A. at 48 (presumption of fairness).

103. *See* Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971) (burden rests with plaintiff absent a showing of fraud).

104. A recent amendment to the Delaware General Corporation Law may, in future cases, limit a director's liability for monetary damages for breaches of fiduciary duty. New § 102(b)(7) authorizes the inclusion of a provision in the certificate of incorporation which would, subject to certain limitations, eliminate or limit a director's liability for monetary damages for breaches of fiduciary duty. Such a provision could not eliminate or limit a director's liability for breaches of the duty of loyalty to the corporation or its stockholders for acts or omissions not in good faith or involving intentional misconduct or knowing violations of law; for the payment of unlawful dividends or unlawful stock repurchases or redemptions; or for transactions in which the directors received an improper personal benefit. Del. Code Ann. tit. 8 § 102(b)(7) (1987).

stockholder even if the challenged decision relates to defenses against a proposed takeover.[105] Traditionally, judicial unwillingness to assess the merits (or fairness) of business decisions ends when a transaction is one "involving a predominantly interested board with a financial interest in the transaction adverse to the corporation."[106] In that situation, a defendant will ordinarily be required to establish the entire fairness of the transaction to a reviewing court's satisfaction.[107]

The abandonment of these traditional burden of proof mechanisms in "transactional justification" cases was most recently explained by Chancellor Allen in *AC Acquisitions Corp. v. Anderson, Clayton & Co.*:[108]

> Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation. Perhaps for that reason, the Delaware Supreme Court recognized in *Unocal Corp. v. Mesa Petroleum Co.* that where a board takes action designed to defeat a threatened change in control of the company, a more flexible, intermediate form of judicial review is appropriate. In such a setting the "omnipresent specter that a board *may* be acting primarily in its own interests," justifies the utilization of a standard that has two elements. First, there must be shown some basis for the Board to have concluded that a proper corporate purpose was served by implementation of the defensive measure and, second,

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105. *Pogostin*, 480 A.2d at 627 ("What we said [in *Aronson*] is equally applicable here in the context of a takeover."). *See also* Gimbel v. Signal Cos., 316 A.2d 599 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974). *Accord Buffalo Forge*, 717 F.2d at 759, *cert. denied*, 464 U.S. 1018 (1983); Panter v. Marshall Field & Co., 646 F.2d 271, 295 (7th Cir. 1981) (applying Delaware law); Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980) (director and largest shareholder of New Jersey corporation did not breach fiduciary duty by failing to disclose contacts with Delaware corporation planning takeover); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980) (fact that corporate directors were to remain on the board after merger did not vitiate the business judgment rule); Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981) (applying Delaware law).

106. *AC Acquisitions Corp.*, 519 A.2d at 111.

107. *Id.* (citing Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1957); Guth v. Loft, 5 A.2d 503 (Del. 1939)).

108. 519 A.2d 103 (Del. 1986).

> that measure must be found reasonable in relation to the threat posed by the change in control that instigates the action.[109]

Thus the rationale for this more flexible standard in "transactional justification" cases derives from the paramount importance of the stockholder rights at issue in takeover situations. Where a disinterested board's decision relates to the management of the daily business of the corporation, there is little likelihood that the board is acting primarily out of its own interests, as opposed to the interests of stockholders. If the board decision in such a case can be attributed to any "rational business purpose," the presumptions of the business judgment rule will apply[110] and a court will not substitute its judgment for the judgment of those charged with the management of the corporation.[111] Directorial decisions relating to control of the corporation in "transactional justification" cases revolve around the ownership rights of the stockholders.[112] In view of the tension in

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109. *Id.* at 111 (quoting *Unocal*, 493 A.2d at 945 (citation omitted).

110. In such a case, it is presumed that the directors "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." *Aronson*, 473 A.2d at 812.

111. *Sinclair Oil Corp.*, 280 A.2d at 720; *Unocal*, 493 A.2d at 954. *See also Aronson*, 473 A.2d at 812 ("Absent an abuse of discretion, [director] judgment will be respected by the courts.")

112. As the court recognized in *Unocal* and *Revlon* such decisions raise the specter that directors may be considering their own interests rather than the interests of the stockholders as the owners of the corporation. *Unocal*, 493 A.2d at 955; *Revlon*, 506 A.2d at 180. In *Dynamics Corp. of Am.*, the Seventh Circuit found that

> When managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the takeover attempt succeeds, they have a clear conflict of interest, and it is not cured by vesting the power of decision in a board of directors in which insiders are a minority . . . .

Dynamics Corp. of Am., 794 F.2d at 256. Similarly, in Minstar Acquiring Corp. v. AMF Inc., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,066, at 91,321 (S.D.N.Y. 1985), Judge Lowe expressed similar reservations regarding the applicability of the business judgment rule to defensive measures:

> [W]e question whether it is appropriate to apply [the business judgment rule] in the context of defensive tactics. The rule was developed to protect directors' judgments on questions of corporate governance . . . . Defensive tactics, however, raise a wholly different set of considerations. The problem is that defensive tactics often, by their very nature, act as a restraint on business purposes. Therefore, the application of the business judgment rule in this context seems, to us, questionable . . . .

Id. The court in *Minstar* concluded, however, that "the weight of authority dictates that the rule be applied." *Id.*

such situations between those rights and the directors' duty to manage the corporation,[113] the "more flexible, intermediate form of judicial review is appropriate,"[114] at least in cases where injunctive relief is sought.[115]

As demonstrated by the chancellor's decision in *AC Acquisitions Corp.*[116] scrutiny under the intermediate form of judicial review can be exacting. The court found that the board of directors' decision to offer stockholders an alternative to an offer by a hostile acquiror served a proper corporate purpose.[117] Nevertheless, the court found the terms of the self-tender approved by the board to be an unreasonable response in relation to the threat posed because the self-tender did not serve, but rather defeated, the purported corporate purpose.[118] "[N]o rational shareholder could afford not to tender into

113. *Revlon*, 506 A.2d at 180; *Unocal*, 493 A.2d at 955.

114. *AC Acquisitions Corp.*, 519 A.2d at 111-12.

115. *Cf. Revlon*, 506 A.2d at 180; *Unocal*, 493 A.2d at 955; *Enstar*, Nos. 7641, 7643, slip op. at 11, *reprinted in* 9 DEL. J. CORP. L. at 829-30. *See also* Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407, 409 (S.D.N.Y. 1985) (involving preliminary injunction enjoining issuance of stock dividend pending trial).

116. 519 A.2d 103 (Del. 1986). The case involved a contest for control of Anderson, Clayton & Co. Plaintiff AC Acquisition Corporation sought an order preliminarily enjoining Anderson, Clayton's self-tender offer for approximately 65% of its outstanding stock at $60 per share cash made in response to plaintiff's tender offer for any and all shares of Anderson, Clayton at $56 per share cash. Plaintiff contended that the self-tender was an economically coercive transaction that deprived stockholders of the option presented by the offer by AC Acquisitions since stockholders who tendered to AC Acquisitions "would thereby preclude themselves from participating in the 'fat' front-end of the [self-tender] and risk having the value of all their shares fall very dramatically." *Id.* at 113. After noting that the record was "uncontradicted that the value of [Anderson, Clayton's] stock following the effectuation of the [self-tender] would be materially less than $60 per share," *id.*; the court found that [t]he only way, within the confines of the [self-tender], that a shareholder can protect himself from such an immediate financial loss, is to tender into the self-tender so that he receives his *pro rata* share of the cash distribution that will, in part, cause the expected fall in the market price of [Anderson, Clayton's] stock. *Id.* at 113-14. It concluded "that an Anderson, Clayton stockholder, acting with economic rationality, has no effective choice as between the contending offers as presently constituted," and preliminarily enjoined effectuation of the self-tender. *Id.*

117. Under *Unocal*, the first inquiry concerns the likelihood that defendants will be able to demonstrate a "reasonable ground for believing that a danger to corporate policy or effectiveness" exists. *Unocal*, 493 A.2d at 955. In *AC Acquisition Corp.*, however, the chancellor noted that he took "this aspect of the test to be simply a particularization of the more general requirement that a corporate purpose, not one personal to the directors, must be served" by the challenged action. *AC Acquisition Corp.*, 519 A.2d at 112.

118. *AC Acquisition Corp.*, 519 A.2d at 113.

the Company's self-tender" since, by not doing so, he would "very likely" run the risk that he would "experience a substantial loss in market value of his holdings" upon consummation of the self-tender.[119] The court enjoined the self-tender as unreasonable because its timing effectively precluded the very choice it was said to create.[120] Thus, directors must be prepared to prove that the defensive measures they adopt to thwart a hostile acquisition and the procedural course they follow in adopting such measures are reasonable in relation to the threat posed.[121]

V. THE CONTINUED VITALITY OF LOCK-UPS

While not per se illegal under Delaware law,[122] lock-ups are apparently less apt to pass judicial muster than before. Both *Revlon* and *Hanson Trust* suggest that directors can only grant a lock-up in a competitive bidding contest when it is in the stockholders' financial interest. Restating this in the *Unocal* formulation:[123] if the directors' only duty is to obtain the highest price and, thus, the only cognizable threat to which they may react is that stockholders will receive less money for their shares, the only defensive actions which *can* be reasonable in relation to that threat are those which either prevent a lower offer from succeeding or increase the chance of success of a higher offer. According to *Revlon* and *Hanson Trust*, lock-ups may be regarded as defensive actions for the purpose of this analysis. Whether a particular lock-up achieved or prevented the highest realizable price for the stockholders is often something that can only be determined, if at all, in hindsight. Nevertheless, in an injunction action, where an active participant in the bidding has topped the "lock-up" bid, hindsight will provide a powerful motivation to enjoin the lock-up and, thus, permit stockholders to receive the higher bid.

The supreme court noted in *Revlon* that lock-up "options can entice other bidders to enter a contest for control of the corporation, creating an auction for the company and maximizing shareholder profit."[124] At the same time, the court noted that lock-ups which are found to prevent stockholders from getting the best price are unlikely to receive judicial approval if challenged:

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119. *Id.*
120. *Id.*
121. *Revlon*, 506 A.2d at 180.
122. *Id.*
123. *Unocal*, 493 A.2d at 955.
124. *Revlon*, 506 A.2d at 183. *See Enstar*, Nos. 7641, 7643, slip op. at 11-12, *reprinted in* 9 DEL. J. CORP. L. at 830.

> 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. Thus, as the trial court ruled, the shareholders' interests necessitated that the board remain free to negotiate in the fulfillment of that duty.[125]

The Second Circuit reached similar conclusions concerning the appropriateness of the lock-up in *Hanson Trust*:

> We remain mindful of our overriding concern . . . that the role of the court in an action to enjoin takeover measures is to allow the forces of the free market to determine the outcome to the greatest extent possible within the bounds of the law. . . . In this regard, we are especially mindful that some lock-up options may be beneficial to the shareholders, such as those that induce a bidder to compete for control of a corporation, while others may be harmful, such as those that effectively preclude bidders from competing with the optionee bidder.[126]

Indeed, in *Enstar*, part of the basis for the court's finding that the directors had acted "reasonably" was that "sufficiently adequate efforts to seek other offers" had been made and only one firm bid had resulted.[127] The court noted that the lock-up might have been invalidated if a firm and viable subsequent offer had been made in a timely manner.[128] Stockholder interests then would have been served by permitting the later willing and able bidder to make a proposal and having the stockholders determine the best offer for themselves in the marketplace.

The principal criticism raised against *Revlon* and *Hanson Trust* is that the lock-ups were reasonable actions because Forstmann Little

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125. *Revlon*, 506 A.2d at 184.

126. *Hanson*, 781 F.2d at 274.

127. *Enstar*, Nos. 7641, 7643, slip op. at 13, *reprinted in* 9 DEL. J. CORP. L. at 831-32.

128. *Id.* at 14, *reprinted in* 9 DEL. J. CORP. L. at 832.

and Merrill Lynch would not have raised their bids without the lock-ups and, therefore, neither the Pantry Pride $58 offer nor the Hanson Trust $75 offer would ever have been made.[129] These criticisms are based on the assumption that the only way a target can get a higher bid is to comply with the favored bidder's demand that no entity be permitted to top its raised bid. White knights such as Forstmann Little and Merrill Lynch are motivated by their own self-interest in bidding. They would not have raised their bids had they not determined that it was in their best interests to do so. In any event, even apart from the lock-up options, both Forstmann Little and Merrill Lynch received significant sums for even entering the bidding contest and risking the possibility that they might not be successful.[130] Such "hello" and "goodbye" payments had already reduced greatly the risk of bidding.

In addition, the lock-ups in *Revlon* and *Hanson Trust* were not given to induce Forstmann Little and Merrill Lynch to enter the bidding in the first instance.[131] The lock-ups were only given to secure marginal increases in existing bids in situations where the other bidder was excluded from dealing with the board.[132] Assuming preferred bidders were convinced of the economic viability of their increased bids—they would not have made them were the case otherwise—it is hard to understand why they might not have bid without lock-ups unless they feared that the other bidder was prepared to pay more.

Revlon and *Hanson Trust* also suggest that courts examining the "reasonableness" of a lock-up as a defensive response will give prime consideration to the nature of the bidding process. A court may be

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129. *See* Lipton, *In Defense of White Knight LBOs*, Legal Times, Aug. 18, 1986, at 9.

130. Merrill Lynch received fees totaling $16.5 million (about $1.37 per share), plus its expenses; these payments were not addressed by the Second Circuit. *See Hanson*, 781 F.2d at 270 n.3. The breakup fee to Forstmann Little ($25 million) was preliminarily enjoined, see *Revlon*, 501 A.2d at 1251-52, but the eventual settlement agreement provided for the payment to Forstmann Little of $20 million, plus its expenses.

131. *Hanson*, 781 F.2d at 267; *Revlon*, 506 A.2d at 178-79.

132. *Revlon*, 506 A.2d at 184. The court noted that "[w]hile Forstmann's $57.25 offer was objectively higher than Pantry Pride's $56.25 bid, the margin of superiority is less when the Forstmann price is adjusted for the time value of money. In reality, the Revlon board ended the auction in return for very little actual improvement in the final bid." *Id. See also Hanson*, 781 F.2d at 270 (no more actual cash put up under $74 offer than in previous $70 offer).

expected to consider the way in which the bidding contest arose and how it was conducted.[133] While a decision to grant a lock-up shortly after the target was put "in play" might be considered unreasonable, a lock-up granted when no other bidders could be located after diligent search by the company or its investment bankers might not.[134]

A decision to grant a lock-up where an active bidding contest has been in progress but appears to be ending can present difficult issues. A lock-up might be appropriate where the directors have reason to believe a favored bidder offering the highest price is close to withdrawing its bid, but not where a favored bidder threatens to withdraw its high bid while other bidders are evaluating a bid and there is reason to believe they may pay more.[135] Certainly where one bidder has indicated that it will top all other offers, as in *Revlon*, that bidder should not be excluded from the bidding.[136] The use of a lock-up has also been criticized in situations where target company management is involved in the favored acquisition group.[137]

The degree to which the competing bidders have been afforded equal access to information required to make their bids may also affect a court's view of the reasonableness of a lock-up.[138] The court

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133. *Revlon*, 506 A.2d at 178.

134. *See Enstar*, Nos. 7641, 7643, slip op. at 13-14, *reprinted in* 9 DEL. J. CORP. L. at 831-32.

135. The court in *Enstar* was troubled by the fact that the Enstar board was advised of a possible new bidder on the day it granted the lock-up. *Id.* at 8, *reprinted in* 9 DEL. J. CORP. L. at 828. However, under the factual circumstances surrounding that possible bid, the court found that the directors acted reasonably in granting the lock-up. *Id.* at 8-10, *reprinted in* 9 DEL. J. CORP. L. at 828-30.

136. *Revlon*, 506 A.2d at 178, 182.

137. *See* Longstreth, *Fairness of Management Buyouts Need Evaluation*, Legal Times, Oct. 10, 1983, at 15 ("Whatever one may think of lock-ups in third party acquisitions, where they might be justified in order to *attract* a competing bid, they seem entirely out of place in a management buyout, where their only apparent purpose is to *prevent* a competing bid." (emphasis added)).

138. In Hecco Ventures v. Sea-Land Corp., No. 8486 (Del. Ch. May 19, 1986), *reprinted in* 12 DEL. J. CORP. L. at 282 (1987), the Delaware Court of Chancery declined to issue a temporary restraining order against the consummation of a cash tender offer made by a subsidiary of CSX Corporation to purchase all outstanding shares of Sea-Land for $28 per share. CSX had conditioned its offer on the granting by Sea-Land to it of an option to purchase 6.5 million shares of Sea-Land stock at $28 per share. In declining to enjoin consummation of the transaction, the court noted that "Sea-Land's directors had authorized a broad search for bids, . . . over five months but yielded only two interested bidders. . . . At no time did Sea-Land favor one bidder over the other. Both received the same

in *Revlon* found that Pantry Pride had been denied access to Revlon financial data, which had been provided to Forstmann Little.[139] Where "the parties [are] not negotiating on equal terms," a lock-up granted to the bidder provided exclusive access to necessary information may not be approved by the court unless the target is able to explain or justify the seeming inequality of treatment.[140]

Where the lock-up involves a stock or asset sale or option, a court may be expected to examine the consideration paid or to be paid in exchange, as well as the directors' method of arriving at it. As the court stated in *Hanson Trust*:

> [G]iven that the very purpose of an asset option in a takeover context is to give the optionee a bargain as an incentive to bid and an assured benefit should its bid fail, . . . one again might have expected under such circumstances a *heightened* duty of care. The price may be low enough to entice a reluctant potential bidder, but no lower than "reasonable pessimism will allow." To ascertain that management's proposal has not crossed this critical line, the Board certainly should have subjected the proposal to some substantial analysis.[141]

Thus, directors must exercise care to make certain that any sale or option of assets is not given for such inadequate consideration as to amount to waste of corporate assets.[142] As *Hanson Trust* appears to indicate, any sale of assets must be at a price that is within the

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information . . . ." *Id.* at 11, *reprinted in* 12 DEL. J. CORP. L. at 289-90. *See also AC Acquisitions Corp.*, 519 A.2d at 110. (plaintiffs requested information to evaluate possibility of increased offer but defendant did not provide information regarding acquisition proposal).

139. *Revlon*, 506 A.2d at 178. But, as one court has noted, the board of a target is not "obliged to accord due process to [a hostile bidder]." *Dynamics Corp. of Am.*, 794 F.2d at 257.

140. In Edelman v. Fruehauf Corp., Nos. 86-71332, -71483, - 72915 (E.D. Mich. July 24, 1986), *aff'd*, 798 F.2d 882 (6th Cir. 1986), the court suggested that a competitive bidding contest had to be conducted "on an even and illuminated playing field."

141. *Hanson*, 781 F.2d at 276. *See also* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 297-98 (1974).

142. A showing of corporate waste may constitute a cause of action against directors separate and distinct from breach of the duty of loyalty or due care. *Hanson*, 781 F.2d at 279 n.9. In addition, a sale of assets pursuant to a lock-up may be challenged, as it was in *Revlon*, under state sale of assets statutes if no stockholder vote is sought to approve the sale of assets. The *Revlon* court made no findings on the issue in view of its findings of breach of fiduciary duty.

range—though possibly at the low end—of fair value.[143] As with any decision to dispose of substantial assets of the corporation, directors do well to receive and familiarize themselves with expert advice on valuation of the assets to be sold or optioned.[144] Similarly, courts have inquired about the relationship between the value of the optioned assets and the incremental increase in price associated with the favored offer. As *Revlon* and *Hanson Trust* indicate, lock-ups may be suspect where given to existing bidders in return for a very small increase in a bid.[145]

Finally, courts have also tried to assess whether or not the favored offer appears to be the best that could be obtained under the circumstances.[146] This may be the most problematical inquiry in cases where no better bid is forthcoming. Among the factors that courts have examined are the value placed on the corporation by the directors, possible break-up values provided to the board by its investment bankers, the existence of a fairness opinion from an investment banker as to the merger price and values obtained for comparable companies.[147]

VI. CONCLUSION

Lock-ups are inherently troublesome and contradictory actions. They are justified when they are used to secure the superior bid but, even then, their function is to discourage or prevent a yet higher

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143. *Id.* at 276.

144. *Id.* at 275.

145. *See id.* at 281-82 & n.11; *Revlon*, 506 A.2d at 184 ("very little actual improvement in the final bid"). *See also id.* at 178 n.6 (Forstmann's offer was worth only $1 more than Pantry Pride's bid).

146. In *Revlon*, Pantry Pride had informed Revlon that it would top any bid by Forstmann Little, the other bidder. *Revlon*, 506 A.2d at 178. In *Enstar*, the court found that the directors had acted reasonably in conducting a search for bids and that the favored offer appeared to the directors to be the best offer attainable under the unusual circumstances present. *Enstar*, Nos. 7641, 7643, slip op. at 13-14, *reprinted in* 9 DEL. J. CORP. L. at 831-32. In *Hecco Ventures*, the court found that "[a]fter a five month search, no other bidder has come forward, no one else has offered more than $28, and there is no evidence that anyone else may or will." *Hecco Ventures*, No. 8486, slip op. at 12, *reprinted in* 12 DEL. J. CORP. L. at 290.

147. In *Hecco Ventures*, the court noted that an independent investment banker had opined that the merger price was fair. *Hecco Ventures*, No. 8486, slip op. at 12, *reprinted in* 12 DEL. J. CORP. L. at 290. In *Enstar*, the court found that "[t]he offer was also in the price range which had been suggested by the directors' investment advisors." *Enstar*, Nos. 7641, 7643, slip op. at 14, *reprinted in* 9 DEL. J. CORP. L. at 832. *But see Van Gorkom*, 488 A.2d at 876 (outside valuation studies not essential to support an informed business judgment).

offer. Thus, in many situations, they can be attacked on the grounds that they defeat rather than promote the stockholders' interests in securing the highest price for their stock. Where the favored bidding group includes members of management, the suggestion of improper purpose is more compelling, as lock-ups are a powerful deterrent to competing offers.

Lock-ups are also different from other defensive measures in that they are often demanded by a "white knight" acquiror as part of the consideration for bidding at all. The "white knight" is, of course, motivated to demand the strongest lock-ups it thinks can survive a court challenge. Thus, a "lock-up" often may not be a purely defensive mechanism but part of the price the board agreed to pay to secure a superior bid. Nevertheless, because the lock-up granted to a favored bidder has the known effect of keeping a better offer from the stockholders, the directors will ordinarily bear the burden of proving the reasonableness of their decision if an injunction is sought.