REINING IN GOOD INTENTIONS: COMMON LAW PROTECTIONS OF VOTING RIGHTS

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ABSTRACT

This brief article questions whether there are situations in which it is inappropriate to review the conduct of corporate directors under the traditional standards of fiduciary duty. The author suggests that the application of a fiduciary duty analysis to questions concerning the propriety of directors' decisions to enter into deal protection measures is misguided. He explains that the application of such an analysis needlessly infuses uncertainty and confusion into board deliberations.

With particular focus on the Unocal *and* Revlon *doctrines, this article provides an analysis of the applicable fiduciary standards of review under Delaware law. Mr. Alexander then argues that both the heightened standard of review and the "non-review" of the business judgment rule are inappropriate standards under which to review decisions to enter into deal protection measures. The author proposes that the review of these decisions should be removed from the realm of fiduciary duty, and instead, should be subject to a non-fiduciary vote coercion analysis. This change would restore a level of certainty and confidence to the board room that would allow directors to act in the best interest of the shareholders that they serve, without the unnecessary fear of breaching their fiduciary duty. The author's position is supported by the recent North Carolina decision in* First Union, *which the article also discusses.*

Transactional lawyers are frequently asked to determine whether certain deal protection measures are acceptable in merger transactions governed by Delaware law. Analyzing judicial precedent, practitioners look for answers in the *Unocal* and *Revlon* doctrines, which impose heightened levels of scrutiny on the conduct of directors in connection with transactions involving, respectively, defensive actions and changes in control.[1] As a number of commentators from both the bench and the bar have suggested, the appli-cation of these standards to deal protection measures creates a

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[1]*See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).

number of uncertainties.[2] These uncertainties are not merely academic. For instance, it is particularly difficult for parties to large and complex transactions to reach an agreement as to terms when the bounds of the permissible terms are unclear. This article suggests that some of the uncertainty surrounding the legality of deal protection measures under Delaware law arises from the mistaken application of fiduciary principles to the regulation of issues involving the stockholder franchise.[3] This article further suggests that, in lieu of fiduciary principles, deal protection measures adopted by disinterested, fully-informed directors should be measured by substantive principles of corporate law that address the effect of such measures on stockholder voting rights. In the recent decision of *First Union Corp. v. Suntrust Banks, Inc.*,[4] the Superior Court of North Carolina appears to have taken significant strides towards such a construct.

I. BACKGROUND

A. *Deal Protection Measures*

Over the last fifteen years, courts have applied heightened scrutiny to the deal protection measures included in merger agreements and related documents[5]. These measures are those generally aimed at ensuring that a merger will occur by reducing the chance that competing bidders will emerge or, if they do emerge, by reducing the likelihood that they will be able to consummate competing transactions. A partial list of such measures includes:

- *Topping Fees.* Fees to be paid to a buyer if a higher offer emerges and the first transaction is not consummated.

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[2]These issues, among others, were addressed at a recent seminar. Judicial Standards of Review of Corporate Fiduciary Action, Standards Seminar sponsored by the Corporation Law Section of the Delaware State Bar Association and Widener University School of Law (May 23, 2001) [hereinafter Standards Seminar]. The Standards Seminar was designed to bring members of the bench, the bar, and the academy together to discuss how the law governing judicial standards of director conduct should progress. This article is offered in the same spirit.

[3]This suggestion is inspired in large part by the insights contained in the closing pages of a recently published article by a sitting Vice Chancellor of the Delaware Court of Chancery. *See* Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919, 941-42 (2001). Many similar ideas were presented in a paper at the Standards Seminar. *See* Gregory V. Varallo & Srinivas M. Raju, *Deal Protections Devices: A Fresh Look*, 26 DEL. J. CORP. L. 975 (2001).

[4]No. 01-CVS-10075 (N.C. Sup. Ct. July 20, 2001) (Order and Opinion).

[5]This article refers to "merger agreements," but of course, the principles also apply to other forms of business combinations such as asset sales.

- *Break-Up Fees.* Fees to be paid to a buyer if the deal is not completed, whether or not a higher offer emerges.

- *No-Shop Provisions.* Provisions that impede the ability of a target to seek out higher offers.

- *No-Talk Provisions.* Provisions that prohibit a target from negotiating with unsolicited interloping bidders.

- *Board Recommendation Covenants.* Covenants limiting the ability of the directors of a target to change their recommendation to stockholders with respect to their vote on the merger.

B. *Fiduciary Duties of Directors*

Like any other director action, the approval of deal protection measures must be made in compliance with a board's fiduciary duties, which require directors to act with due care, loyalty, and good faith on behalf of the corporation and its stockholders. Absent a conflict of interest, challenges to directors' compliance with these duties are subject to the business judgment rule, which places a heavy burden on a plaintiff seeking to establish a breach of fiduciary duty. Indeed, as stated in one paper presented at the Standards Seminar, the business judgment rule "is an expression of a policy of non-review of a board of directors' decision."[6] The business judgment rule encourages directors to take calculated risks and recognizes that, absent unusual circumstances, the boardroom, rather than the courtroom, is the appropriate venue for business decisions to be made. The use of the business judgment rule represents a policy decision that the benefit of *ex post facto* review of board decisions by courts (stockholder protection) is outweighed by its detriments (the discouragement of beneficial transactions).[7]

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[6]William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1297 (2001).

[7]This discouragement of beneficial transactions created by *ex post facto* review has two sources. First, directors themselves may be hesitant to commit a corporation to a beneficial but risky course if they feel that they will be judged in hindsight if the decision has a negative outcome. Second, and perhaps more significant, third parties may be deterred from entering into transactions if they feel that is a significant chance they will be denied the benefit of their bargain. Thus, a supplier of a commodity would be discouraged from entering into a long-term "take or pay" contract with a corporation if the supplier suspected that, in the event that the price of the commodity fell, the transaction would be invalidated as a breach of the corporation's directors' duties.

There are, of course, important exceptions to this rule. Decisions involving conflicts of interest at the board level may be subject to the entire fairness test, which carries a much higher standard of scrutiny, in order to protect stockholders from self-dealing by directors. Here, presumably, the policy tradeoff is that the risk of discouraging conflict transactions by subjecting directors to a higher standard of scrutiny is outweighed by the benefits of protecting stockholders from self-dealing.

In *Unocal*, the Delaware Supreme Court established an intermediate standard to be applied "[w]hen a board addresses a pending takeover bid."[8] The court held that while the presence of such a bid did not create a pure conflict of interest requiring the application of the entire fairness test, there was an "omnipresent specter that a board may be acting primarily in its own interests" to preserve the directors' offices, and therefore, the business judgment rule did not automatically apply.[9] Instead, the directors who acted to defend against the takeover were required to show that they perceived a threat to corporate policy and effectiveness, and acted in a manner that was reasonable in relation to that threat.[10] Underpinning the heightened scrutiny concept was the concern that directors, in taking "defensive" actions, would either consciously or unconsciously act in their own interests to preserve their corporate office. Thus, in *Unitrin, Inc. v. American General Corp.*,[11] the Delaware Supreme Court stated that it "recognized that directors are often confronted with an '"inherent conflict of interest" during contests for corporate control.'"[12]

Soon after the *Unocal* decision, the Delaware Supreme Court decided *Revlon*, in which it applied heightened scrutiny to a sale of a corporation to a third party.[13] While *Revlon* involved a situation in which the deal protection measures at issue related to a transaction that the board had entered into in response to a hostile bid from a different party, and while the *Revlon* court clearly viewed itself as applying *Unocal* to the facts at issue,the case came to stand for an independent requirement that heightened scrutiny be applied to all "change in control" transactions.[14]

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

[9]*Id.*

[10]*Id.* at 955.

[11]651 A.2d 1361 (Del. 1995).

[12]*Id.* at 1373 (quoting Stroud v. Grace, 606 A.2d 75, 82 (Del. 1992) (quoting *Unocal*, 493 A.2d at 954)).

[13]*See* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).

[14]*See id.* at 184.

II. A HEIGHTENED FIDUCIARY STANDARD IS NOT THE APPROPRIATE VEHICLE FOR REVIEWING DEAL PROTECTION MEASURES

A. *Mergers Do Not Involve the "Omnipresent Specter" That Calls for a Heightened Standard of Review*

The decision to enter into a merger agreement is a quintessential business judgment. Assuming that a board is non-conflicted, fully informed and acting in good faith, there is no apparent reason to apply a heightened standard of judicial review to a board's compliance with its fiduciary duties in the merger context. The policies that the business judgment rule supports, such as the encouragement of entrepreneurship and calculated risk-taking, the deference to the expertise of business persons versus the expertise of courts in business matters, and the value of the certainty in business transactions, are all present in mergers. Furthermore, where a majority of directors will not continue to serve as directors of the merged corporation, the "omnipresent specter" that directors are acting to preserve their positions is not applicable.[15]

Perhaps one reason for the trend toward applying heightened scrutiny to all merger transactions is the fact that a number of the significant cases that set forth the applicable standards involved mergers that were direct responses to unsolicited bids.[16] For the most part, however, merger

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[15]Vice Chancellor Strine has suggested otherwise:

> From experience, can practitioners really look themselves in the mirror and tell themselves that the typical stock-for-stock merger does not raise the sorts of concerns that led to the creation of the *Unocal* standard? Is it not the case that issues relating to managerial and board positions frequently dominate the discussions? Is it unknown for directors to be willing to merge with anyone but "those bastards"? Aren't there non-*Revlon* mergers that are entered into precisely so that the merger parties can avoid being swallowed up by bigger industry players?

Strine, *supra* note 3, at 931. The answer to the last three questions is certainly yes; that is, there are mergers in which directors continue as directors of the merged company and where there are perhaps other reasons for fearing the "omnipresent specter." Nevertheless, the answer to the first question is also yes. The *typical merger* is one in which the sales process is favored by the board, and in which few, if any, of the directors of the target will have continuing positions with the merged company. In fact, observers unfamiliar with the cases might believe that the decision *not* to merge is more likely to be motivated by a desire to preserve one's corporate office than is the decision to merge. *See* Rob Walker, *Lucent's Acquisition Epiphany, at* http://slate.msn.com/moneybox/entries/01-05-30_109015.asp (last modified May 30, 2001).

[16]*See, e.g.*, Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988); Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986). In a fourth of the important Delaware Supreme

transactions are simply business transactions, albeit important ones, and present no heightened risk that directors are acting wholly or partially to protect their corporate office. Accordingly, the policy underlying *Unocal* does not suggest that a heightened standard of review should be applied to merger transactions or associated deal protections generally.[17]

B. *The Business Judgment Rule Is Not an Appropriate Standard for Judicial Review of Deal Protection Measures*

As noted in the previous section, there does not appear to be a coherent policy reason for applying a heightened standard of review to directors' exercise of their fiduciary duties in adopting deal protection measures outside the *Revlon* context.[18] Nevertheless, it would be inappropriate to simply leave those provisions to the "non-review" standard of the business judgment rule.[19] Such measures have the potential to significantly affect the stockholder franchise. Before a corporation can effect a merger, its stockholders must approve that merger.[20] Draconian deal protection measures may have the effect of eliminating or drastically reducing the stockholders' free choice. The importance of protecting the integrity of the stockholder voting process was described by the chancery court in *Blasius Industries v. Atlas Corp.*[21]

> [W]hether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own. Thus, when viewed from a broad, institutional perspective, it can be seen that matters

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Court merger cases, the target was aware of the interest of a third party with whom management did not want to merge. *See* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 38 (Del. 1993). It is not surprising that the decided cases have this aspect. Where no higher bid emerges, it is unlikely that deal protection measures will be vigorously litigated, no matter how preclusive. Where, on the other hand, a higher bid does emerge, the measures are likely to be hotly litigated, even if quite reasonable. And, of course, where there is a prior hostile bid or knowledge of a potential bid, the likelihood of a higher bid emerging is very great. Accordingly, defensive mergers and the related deal protections are much more likely to be litigated than are mergers that have little or no defensive aspect.

[17]Of course, the logical extension of this argument is that the heightened fiduciary standard established in *Revlon* should not be applied to non-defensive change in control transactions. The author prefers to tilt at one windmill at a time.

[18]*But see supra* note 17.

[19]*See supra* note 6 and accompanying text.

[20]*See, e.g.*, DEL. CODE ANN. tit. 8, § 251(b)-(c) (2000).

[21]564 A.2d 651 (Del. Ch. 1988).

> involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power.[22]

This appears to be precisely the conclusion reached by the North Carolina court in *First Union*. In its analysis of a stock-for-stock transaction, the court, following a long and exhaustive review of the relevant Delaware precedent, reviewed two deal protection measures.[23] One of the measures was a stock option lock-up and a termination provision that prevented Wachovia, a party to the merger agreement, from terminating the merger agreement for a five month period after the time at which its stockholders voted against the deal.[24] The court explained that:

> [a]s long as the decision to include the deal protection measures in the merger transaction was informed and in good faith, it will not be disturbed by the courts absent proof by clear and convincing evidence of interference with shareholder voting rights or statutory duties. The directors' duties and standard of care applied to them are no different from any other situation.[25]

Accordingly, to the extent that deal protection measures do affect the integrity of stockholder votes, there must be judicial review to insure that the integrity of the voting process is maintained.[26]

C. *A Fiduciary Duty Standard Cannot Address the Stockholder Franchise Issues Raised by Deal Protection Measures*

As noted above, there does not appear to be any coherent policy reason for applying a heightened standard of review to the directors' exercise of their fiduciary duties in adopting deal protection measures. There is,

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[22] *Id.* at 659.

[23] First Union Corp. v. Suntrust Banks, Inc., No. 01-CVS-10075 (N.C. Sup. Ct. July 20, 2001) (Order & Opinion).

[24] *Id.* ¶ 118.

[25] *Id.* ¶ 72.

[26] This is not a radical proposition. Courts have long recognized that board action interfering with stockholder voting is subject to common law limitations. *See* Schnell v. Chris-Craft Indus., 285 A.2d 437 (Del. 1971). For the most part, however, the *Schnell/Blasius* line of cases address situations where there is some element of defensiveness, and therefore some level of heightened fiduciary review is appropriate.

however, a more fundamental problem with applying *Unocal* as the standard of review to deal protection measures. Judicial review of the exercise of a board's fiduciary duties, regardless of the standard, will not act as a coherent check on overly coercive deal protections. This point follows from a fundamental economic reality: *the contingency of stockholder approval and the concomitant possibility of topping offers tends to reduce the bid price for a corporation.*[27] This reduction has two sources. First, the risk of being topped creates uncertainty, which detracts from value. Thus, a buyer who could purchase two identical assets for the same price will prefer the transaction involving fewer contingencies. In addition, there is some differential that the buyer will be willing to pay for the elimination of the contingencies.

Second, the public announcement of the signing of a merger agreement, coupled with the stockholder vote contingency, will discourage a buyer from submitting its highest bid. Where a winning bid is subject to an additional round of bids, whether explicit or implicit, a rational bidder will reserve some of its top price in order to see if it can get a bargain. The sixty to ninety-day post-signing period during which a higher bid could emerge tends to reduce the bid price for public corporations. Courts have recognized this fact in analyzing whether *directors* must preserve for themselves the right to take higher offers.[28]

The following hypothetical illustrates this conundrum. Take a company selling for $10 per share that, after a board-initiated and targeted shopping process, receives a bid of $19 per share. Based on previous discussions with other bidders and the advice of its management and investment bankers, the directors determine that there is a twenty percent chance that an offer of $22 per share could emerge between the signing of

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[27]If this statement is too strong for the reader's taste, the following diluted version may be substituted. In some circumstances, directors may reasonably perceive that the contingency of stockholder approval and the concomitant possibility of topping offers may reduce the bid price for a corporation being sold.

[28]*See* Renaissance Communications Corp. v. National Broad. Co., No. 14,446, 1995 WL 1798510 (Del. Ch. Aug. 1, 1995).

> [I]f the fiduciary duty always overrides an auction, you have just made auctions less valuable, because people obviously won't have the incentive to issue the best price. So it is self-defeating for the fiduciary law to say in all events a higher and later price gives rise to a fiduciary obligation to breach the contract.

Id. at *14. To see the point, replace the phrase "fiduciary duty" in the first sentence with "stockholder vote." *See also* Jewel Cos. v. Pay Less Drug Stores Northwest, Inc., 741 F.2d 1555, 1563 (9th Cir. 1984) (discussing the use of deal protection meausres in merger agreements).

> A potential merger partner may be reluctant to agree to a merger unless it is confident that its offer will not be used by the board simply to trigger an auction for the firm's assets. Therefore, an exclusive merger agreement may be necessary to secure the best offer for the shareholders of a firm.

Id.

the agreement and the stockholder vote. Thus, the $19 per share deal actually provides a risk-adjusted premium of $9.60 to the stockholders, i.e., the value of the eighty percent chance of the $19 per share deal ($7.20 per share) added to the twenty percent chance of closing the $22 per share deal ($2.40 per share). However, the board's advisors suggest that the buyer is holding out and will actually pay up to $20 per share. The board then counteroffers at $20 per share.

When presented with this counteroffer, the buyer tells the target that if the target is willing to enter into draconian and preclusive lock-ups to insure that a higher bid will not succeed (e.g., a 100% break-up fee and a five-year, non-redeemable pill), then it will be willing to put the full $20 per share, its last nickel, on the table. This deal has a value of $10 per share (100% times $10).[29] Since $10 is more than $9.60, an unconflicted, fully informed director acting in good faith could *reasonably* pick the fully-locked deal.[30]

In other words, in order to fully maximize value, directors might determine that it is necessary to enter into provisions that completely preclude higher offers, or that coerce the stockholders into voting for the deals. Presumably, such provisions that completely coerce the stockholder vote are invalid, and a court would not enforce such provisions even if it could be shown that the directors were fully informed, unconflicted and acting in good faith, and even if it could be shown that the provisions were necessary to maximize stockholder value at the time they were entered into. In other words, the legal flaw is in the provisions themselves and not in the directors' conduct in adopting them.[31] Accordingly, deal protection mechanisms need to be regulated by something other than applicable fiduciary law.

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[29]Of course, the value of a non-locked, $20 per share deal is worth more than $10 per share, but that choice is not available to the directors.

[30]It is not helpful to assert that such a contract would require the board to breach its fiduciary duty at a later time, by, for example, not redeeming the pill if the higher offer emerges. *See supra* note 7. Directors entering into a merger agreement must exercise their fiduciary duties at the time they enter into a contract. Moreover, it simply cannot be that fiduciary law requires directors to pick the offer with a lowr value.

[31]In *Blasius*, the directors were facing a hostile proxy contest pursuant to which they would lose control of the corporation. The court found that a board acting in good faith could nevertheless take an action that "constituted an unintended violation of the duty of loyalty," suggesting that, perhaps, the vote coercion issue could be addressed within the fiduciary duty paradigm. *Blasius*, 564 A.2d at 663. *Blasius*, however, is distinguishable because it involved truly defensive actions.

III. DEAL PROTECTION MEASURES SHOULD BE SUBJECT TO A NON-FIDUCIARY VOTE COERCION ANALYSIS

Deal protection measures are quintessential business judgments and, absent conflicts of interest or evidence of truly defensive motives, the directors' conduct in adopting such provisions should be subject to the business judgment rule. These measures, however, should be subject to judicial review to insure that they do not effectively strip stockholders of their statutory right to vote on certain transactions.[32] This categorical clarification should have significant consequences.

First, recognizing that the judicial review of deal protection measures does not automatically call for a *Unocal* analysis will enable courts to treat mergers that are truly defensive under a real *Unocal* standard, rather than having such defensive mergers grouped together with all mergers. Currently, the law that regulates defensive board *conduct* is blurred with the law that more properly regulates the *content* of the deal protection measures themselves.

Second, the classification will restore some coherence to board deliberations. It is very troubling for directors to be told that a deal protection measure that may actually bring more value to their stockholders is a breach of their duty. Directors currently must be advised that they cannot take a higher offer that is linked to deal protection measures because they may be personally liable, or publicly labeled as breachers of fiduciary duties, for doing so. In a perverse way, this forces directors to put their own interest before the interest of the stockholders.

Third, recognizing that the invalidity of deal protection measures is inherent in the measures themselves, rather than resulting from directorial misconduct in their adoption, also relieves the court from dealing with the paradox that third parties, i.e., buyers, are denied the benefit of their bargains because of a breach of duty by the directors of the target. In other words, by taking the issue out of the fiduciary box, the reason for placing the risk of invalidity on the buyer becomes more clear.

Fourth, the shift would allow courts to approach deal protection measures in a more rational manner. When courts are forced to analyze a break-up fee by deciding whether the directors who approved it were loyal and careful, there is simply a disconnect. The real question at issue is whether, and to what extent, the break-up fee forces the stockholders' collective hand. Fiduciary standards measure board conduct and, by their nature, cannot be used to evaluate content.

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[32]*See* Strine, *supra* note 3, at 941-42.

An example of this is seen in *First Union*, where the court applied precisely this analysis. After finding that the board had met its duty of care in adopting the defensive provisions, it considered whether those provisions precluded stockholder choice with respect to their vote on the merger.[33] As to the break-up fee, the court determined that "there [was] no downside for Wachovia shareholders if the merger [was] defeated."[34]

Fifth, a vote coercion analysis is more amenable to per se rules and safe harbors. The value of such rules should not be underestimated. The flexibility to agree to deal protection measures provides value to stockholders, not just to buyers. This value is available, however, only if the buyer believes that it will in fact get the benefit of its bargain. Otherwise, the buyer is left with the very uncertainties that the measures are designed to alleviate.

Finally, the adoption of a vote coercion standard may constitute a first step back from what might be viewed as a more general "over-fiduciarization" of the corporate law. It could be argued that the application of fiduciary duties to deal protection measures is just one example of an area where the regulation of the relationship between the corporation, its stockholders, and its directors has been inappropriately subjected to fiduciary analysis.[35] Much of the case law involving heightened scrutiny appears to involve careful, unconflicted directors acting in good faith. These cases, which involve the proper allocation of power among the various corporate constituencies, appear to be about substantive corporate law, not directorial misconduct. For example, it might be argued that rights plans must be subject to heightened scrutiny because they inhibit the rights of stockholders to vote and to transfer their shares, regardless of how the directors conduct themselves in connection with decisions regarding the rights.[36] Judicial

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[33]*First Union*, No. 01-CVS-10075, slip op. ¶ 147.

[34]*Id.* The court went on to say that "[t]his is not a situation where the Wachovia shareholders are faced with some catastrophic consequence if they vote against the merger." *Id.*

[35]One recent case went so far as to suggest that a company's sale of substantially all its assets without obtaining the required vote of stockholders under title 8, section 271 of the Delaware Code constituted a breach of the directors' fiduciary duty. *See* Apple Computer, Inc. v. Exponential Tech., Inc., No. 16,315 (Del. Ch. Jan. 21, 1999), *reprinted in* 24 DEL. J. CORP. L. 949 (1999).

[36]*Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998), presents a related example of over-fiduciarization. In *Quickturn*, the Delaware Supreme Court invalidated a rights plan that became non-redeemable for a six month period following the election of a dissident board. *Id.* The court reasoned that the delayed redemption provision was invalid because it prevented a newly elected board of directors from completely discharging its fiduciary duties: "'[t]o 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.'" *Id.* at 1292 (quoting Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 51 (Del. 1994)). The emphasis on the limitation of the right to satisfy future fiduciary duties seems misplaced, however; after all, the poison in a poison pill is effective because, at a certain point in time, it becomes non-

protection of those rights is necessary to legitimize the directors' exercise of power "over vast aggregations of property" belonging to stockholders.[37] Accordingly, it is substantive corporate law, and not fiduciary principles, that is really at issue.[38]

By way of example, the following deal protection measures could be analyzed as follows:

Board Recommendation Covenants. Under title 8, section 251, of the Delaware Code, the board of directors is free to change its recommendation between the time that a merger agreement is entered into and the time that stockholders vote.[39] Covenants that prohibit a board from changing its recommendation or that limit the circumstances in which they can do so have no effect other than interfering with the fully informed stockholder vote. These covenants are therefore clear candidates for being struck down under the vote coercion analysis. The fiduciary duty analysis is not so clear, since it could always be argued that the recommendation provision, though distasteful to the directors, was useful in obtaining something of value from the other side, such as a parallel covenant or an extra $.50 per share.

Topping Fees. A topping fee, i.e., a fee payable to a bidder if another purchaser acquires the target within some period of time, is, in one sense, not coercive at all since there is no penalty if the stockholders simply vote the deal down without taking a higher offer. In another sense, the fees are mildly coercive in that they do not permit stockholders to choose between the deal on the table and a deal from a bidder who would be willing to pay an amount equal to the first bid, plus an additional amount up to the size of the fee. Thus, the vote is coerced, but only in the sense that stockholders are denied the opportunity to vote on an incrementally higher bid.

Naked No-Vote Fees. Break-up fees payable solely because the target stockholders vote against the deal do, of course, coerce the vote in that stockholders will pay a price if they exercise their franchise to vote down a deal that they do not like. On the other hand, the coercion is proportional to the fee, and if the amount payable is small then the coercion may be unobjectionable. There is, however, certainly room to argue that any penalty imposed on a pure vote violates the policies behind title 8, section 251.

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redeemable. It is arguable that the real problem with the delayed redemption provision was that it did not allow stockholders to freely choose whom to elect as directors, since nominees favored by the current board would have powers denied to nominees not favored by the current board.

[37]*Blasius*, 564 A.2d at 659. *See supra* note 23 and accompanying text.

[38]The current situation is as if the members of Congress and the President were being treated as having breached duties to citizens of the United States by adopting a statute that was later found to exceed the powers granted to the federal government under the Constitution. While the Supreme Court needs to enforce the Constitution, in doing so it is not necessarily regulating the conduct of the members of the government.

[39]DEL. CODE ANN. tit. 8, § 251(b)-(c) (2000).

Covenant to Leave Pill in Place. Where such a covenant exists only during the period between the signing of the merger agreement and the vote, it seems that the coercive factor is small since stockholders can reject the deal and move onto the next one. Where, on the other hand, the covenant extends beyond the voting down of the transaction, it seems that there is a purely coercive factor, in that stockholders are not permitted to move on to the next deal.

In reviewing the "numb hands" provision of the merger agreement at issue, the *First Union* court found that provisions limiting the ability of a corporation to enter into merger agreements following the time that stockholders voted the deal down were, in fact, coercive of the stockholder vote, and therefore invalid. Significantly, the court found that:

> [t]he existence of the non-termination clause in this case demonstrates why a simple application of the business judgment rule fails to afford protection to shareholders. Here, the Court has found that the Wachovia Board acted in good faith, on an informed basis and in the best interests of the corporation in entering into the merger agreement with non-termination clause included. The directors had good advisors and they properly relied upon them. If the business judgment rule were the sole determinant or review process, the non-termination clause would not be subject to further review. With the review process adopted by the Court, the non-termination clause gets reviewed for the specific reason that good public policy requires — directors must fulfill their fundamental statutory obligations and shareholders should have an uncoerced vote.[40]

This article does not mean to suggest that replacing the fiduciary standard of review with a franchise standard of review would eliminate hard cases. Even if the change permitted courts to draw clear lines, practitioners would devise ways to blur those lines. This article suggests that this change will help courts and practitioners to focus on the real policy issue at stake in deal protection measures and, perhaps, with such a clear policy base, devise a more coherent framework for addressing these issues.

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[40]*First Union*, No. 01-CVS-10075, ¶ 152.