Commentary from the Bar

THE NEW INCARNATION OF THE BUSINESS JUDGMENT RULE IN TAKEOVER DEFENSES

By E. Norman Veasey*

It is impossible to be very brief in attempting to rationalize the substantive and procedural framework of state law[1] applicable to defensive maneuvers. Boards of directors, all over the country are meeting—even as we speak—to consider rights plans (sometimes pejoratively called "poison-pills") and other defenses to unwanted takeovers.[2] Directors are plowing through materials, listening to their general counsel, outside counsel, takeover specialists, investment bankers and others, considering the company's vulnerability to a takeover and contemplating protective steps which might be taken. Some boards are responding in a crisis atmosphere to a specific tender offer, while in others, such considerations occur in the pre-planning phase before any takeover attempt has been launched. This concept is important in the context of *Moran v. Household International, Inc.*,[3] the principal case which is the backdrop against which the drama is currently being played out.

Many boards have already gone to their annual meetings of stockholders with proposed charter amendments incorporating "shark

---

An earlier version of this article was published in The Legal Times of Washington, Mar. 10, 1986, at 25.

 Mr. Veasey is a member of the Wilmington, Delaware, firm of Richards, Layton & Finger. This article is adapted from a speech delivered by the author to the 132th Annual Institute on Securities Regulation of The University of California on January 23, 1986. The author is deeply indebted to Jesse A. Finkelstein and Kevin G. Abrams, of the firm of Richards, Layton & Finger. Messrs. Finkelstein and Abrams are principally responsible for the content of the 133-page, comprehensive paper submitted to the Institute on Securities Regulation entitled, Veasey, Finkelstein & Abrams, *Selected Tactics in Control Contests: Poison Pills, Lock-Ups, Stockholder Consents; Application of the Business Judgment Rule and Allocating the Burden of Proof* (Jan. 8, 1986).

1. Since the United States Supreme Court decision in Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977), it has been clear that it is state law, not federal law, which governs substantive corporation law.

2. *See* Corporate Control Alert (Feb. 1986) (listing the corporations which have adopted anti-takeover defenses based on various types of rights plans or disparate voting rights).

3. 500 A.2d 1346 (Del.), *aff'g*, 490 A.2d 1059 (Del. Ch. 1985).

repellents" such as staggered boards, fair pricing provisions, supermajority provisions, elimination of consent in lieu of a meeting, and other measures.[4] These steps, however, may be of limited effectiveness either against a two-tiered offer or against an all-cash offer.[5] Often something more dramatic must be done.

A board which is confronted with a specific hostile takeover bid must react quickly to take a position. If the bid is inadequate, the directors must develop and implement defenses, analyze financial and legal issues, arrange corporate details, engage in litigation, and take proper steps to improve their negotiating position. All this takes place around the clock in a pressure cooker at a frenetic pace. Many steps may be taken in this context, including self-tenders, white knight deals, lock-ups, litigation, "Pac-Man" strategies, sale of crown jewels, acquisitions to create antitrust problems, and other devices.

The Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*[6] held that the board of directors had wide latitude to take effective measures. That case upheld the use of a self-tender which discriminated against the bidder. The justification, as found by the court, was that the board perceived a threat to corporate policy from a "raider" with a front-end loaded, coercive tender offer which the board thought might lead to "greenmail." The court held that the board met the criteria of the business judgment rule and the novel burden of proof standards which will be discussed later.[7] While considerable deference was given to the good faith determinations of the board of directors, the court said a board may not take steps which are "draconian" in defending against a takeover. The principal focus of this discussion revolves around the tactics and legal issues which were unique to the *Unocal* situation, as well as other "heat of battle" defensive tactics which are relevant to, but may be distinguishable from, the issues involved in pre-planning.

The ultimate question in all these cases is: what deference will the courts pay to the decisions of directors in defending against a

---

4. *See* Huber, *SEC Review of Proxy and Tender Offer Material: Recent Administrative Experience*, 13th Annual Institute on Securities Regulation (University of California, San Diego, Jan. 22-24, 1986).

5. *See* Note, *Defensive Strategies and the Business Judgment Rule: Does Almost Anything Go in Delaware?*, 11 DEL. J. CORP. L. 535 (1986) (discussion of takeover defenses in relation to two-tiered offers and all-cash offers).

6. 493 A.2d 946 (Del. 1985).

7. *See infra* note 12 and accompanying text.

8. Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

takeover? The matter normally arises in an injunction proceeding, a posture which is sometimes referred to as "transactional justification." The deference given to directors' decisions and the burden of proof requirements in transactional justification contexts may differ substantially from the traditional application of the business judgment rule. Historically, the business judgment rule has been applied as a shield to protect directors from personal liability for damage to the corporation arising out of a completed transaction. It is presumed that decisions of disinterested directors are made in good faith for a rational business purpose, with due care, and in the honest belief that they are acting in the best interests of stockholders.[8] These decisions are often "enterprise" or operational issues ("shall we buy a new truck?" or "shall we give Mary a raise?").[9] In transactional justification cases such as defenses to takeovers, the issues revolve around stockholder ownership rights and values. In transactional justification cases, the business judgment "rule" or "doctrine" is said to protect the decision itself, rather than the decision makers.[10]

The distinguishing characteristics go further than mere nomenclature, however. In the defensive business judgment rule cases, the courts' scrutiny of the substantive decision is limited to the inquiry of whether or not the decision can be attributed to a "rational business purpose."[11] This is qualitatively distinguishable from whether the substantive decision meets the objective standard of "reasonableness."[12]

On the other hand, the courts are becoming much more active in scrutinizing the "process" by which the board reached its decision to see if the directors have exercised their business judgment with due care (i.e., without being "grossly negligent") after informing themselves of all material facts reasonably available to them.[13] Never-

---

9. *See* Minstar Acquiring Corp. v. AMF, Inc., [1984-1985 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,066 (S.D.N.Y. June 6, 1985); Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1 (1985).

10. *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 (1985).

11. *Sinclair Oil Corp.*, 280 A.2d at 720.

12. *See* Veasey, *Further Reflections on Court Review of Judgments of Directors: Is the Judicial Process Under Control?*, 40 BUS. LAW. 1373 (Aug. 1985); Veasey, *Seeking a Safe Harbor From Judicial Scrutiny of Directors' Business Decisions: An Analytical Framework for Litigation Strategy and Counselling Directors*, 37 BUS. LAW. 1247 (Apr. 1982); Veasey, *Codified Standard—Safe Harbor or Uncharted Reef?*, 35 BUS. LAW. 919 (Apr. 1980). *See also* The American Law Institute (ALI), *Principles of Corporate Governance: Analysis and Recommendations*, commentary to § 4.01 (Tentative Draft No. 4, May 17, 1985).

13. *Aronson*, 473 A.2d at 814-15; Smith v. Van Gorkom, 488 A.2d 858 (Del.

theless, in the application of the "defensive" business judgment rule, the presumptions of good faith, disinterestedness, rational business purpose, due care, and honest belief in the stockholders' best interests are with the directors. Thus, a plaintiff in a derivative suit has the burden of going forward with the evidence and the burden of ultimate persuasion on all these issues. This is true even if the directors are sought to be held personally liable for damages in a derivative suit for allegedly damaging the corporation by an ill-advised defense to a tender offer.[14]

In a transactional justification case such as a defense to a takeover, however, new standards of jurisprudence and judicial review are emerging. Here, "reasonableness" becomes an issue and in some respects the burden of going forward with the evidence is placed on the directors. Let us look first at the *Household* decision and then return to an analysis of the new burden of proof rules and their rationale.

In *Household*, the board of directors without stockholder approval adopted a "Rights Plan" containing a "flip-over" feature which would require that, in the event of a second-step merger, stockholders would be entitled to buy the stock of the "raider" for half price. Well before adopting the Rights Plan, the board of Household had become concerned about vulnerability to a takeover. They considered seeking stockholder approval of shark repellent charter amendments, but decided against proceeding in that manner. John Moran, one of the directors and a principal investor, had suggested a leveraged buyout. Studies had shown that the stock was significantly undervalued in relation to the break-up value of the corporation. Companies with undervalued stock in the financial services industry, where Household was prominently placed, were perceived as vulnerable, particularly to two-tiered, "junk bond" financed "bust up" tender offers. The directors received advice from various inside and outside counsel and a variety of financial and investment banking advice. Prior to the meeting at which the Rights Plan was adopted, materials (including a notebook with a summary of the plan, financial analyses, questions and answers, articles, and other literature) were distributed. There was a full discussion at the meeting at which Mr. Moran, who obviously opposed the plan, argued forcefully against it. The

---

1985); R. BALOTTI & J. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.6-.7 (1985).

14. 480 A.2d 619 (Del. 1984).

Delaware courts found this to be helpful in evaluating the board's process and methodology. Mr. Moran was a "knowledgeable critic" whose analysis in the give and take of the extended discussion period focused the directors' attention on the important issues involved in the Rights Plan.

Although there was no pending or threatened hostile bid, the Household board adopted the Rights Plan in light of the perceived general vulnerability to a takeover threat. The Rights Plan involved the issuance of one right to each holder of common stock. This right would trade with the common stock until it was exercised. The rights would become exercisable in either of two events—a tender offer for 30% of the stock or the acquisition by one holder or group of 20% of the stock. Prior to such a 20% acquisition, the right would be redeemable for fifty cents per share. As long as redemption was available, the board could negotiate with the bidder, make a friendly merger, or other deal. The redemption feature, which gives the board enhanced power to negotiate, may lead to an enhanced fiduciary duty on the part of the board. If not redeemed, the rights would operate in a second-step merger permitting the holder to exercise the right to obtain $200 worth of common stock of the acquiror for $100 (i.e., a 50% discount). This was the "flip-over" provision which made the Rights Plan work and upon which the litigation centered.

Aside from certain technical corporation law issues, Moran challenged the Rights Plan on the ground that it was inherently an entrenchment device because it purportedly made Household "takeover proof." After a full trial on the merits involving the testimony of the directors, their advisors, expert witnesses, and others, the court of chancery found that it did not prevent all takeovers. The supreme court affirmed. [15] There are antidotes for the pill and other measures which might be used by a creative raider to get around the pill. The supreme court itself noted some of the ways around the *Household* plan.[16]

While the court upheld the right of the board in *Household* to put the pill in place, the court noted that the board nevertheless had fiduciary duties which would be subject to later review in the context of a specific takeover threat. By putting itself in a position where it

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

16. *Id.* at 1354 (reviewing the impact of rights plans adopted in previous circumstances).

has enhanced negotiating power, the board may have intensified its exposure to claims of violations of fiduciary duty. Paradoxically, it is this negotiating power which was the central justification for the plan, as the power was designed primarily to protect the stockholders' interest and not to entrench management.

The pre-planning argument in *Household* cuts both ways. Language in the *Unocal* opinion, that the board's defensive tactics must be "reasonable in relation to the threat", was used by plaintiff in *Household* to argue that there must be an actual threat. Moran also argued that the "pre-bid planning" strategy represented a presumptive determination by management and the board to oppose *any* acquisition bid, regardless of its merits. Many corporations had made significant efforts prior to *Household* to protect their stockholders in response to specific, harmful takeover bids and there was some authority supporting advance preparation.[17] Nevertheless, there was no clear protection afforded to planning actions preceding a takeover bid such as the Rights Plan. Ultimately, the supreme court in *Household* held that such pre-planning was a factor in the board's favor because it reduced the risk that "under pressure management will fail to exercise judgment." The court found that pre-planning was even more appropriate than hasty reactions to specific hostile bids.

The gnawing concern of the courts in cases involving takeover defenses is whether the board has an "inherent conflict" in deciding whether or not to oppose a bid and what methods should be used. Since a successful defense to a takeover will inevitably result in a continuation of the board in control, the motives of the board become an issue. Although the courts recognize that the board has the right and the duty to oppose a harmful bid, the board's decision must not be motivated "solely or primarily" to entrench themselves in office.[18] Preventing a raider from taking over and committing acts which are detrimental to "corporate policy and effectiveness" must be motivated by a rational business purpose.[19] But how can it be shown whether or not the board was solely or primarily motivated by its own self-interest? The burden of ultimate persuasion belongs with the plaintiff to show that the board was solely or primarily

17. *See* National Educ. Corp. v. Bell & Howell Co., No. 7278 (Del. Ch. Aug. 25, 1983).

18. Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), *cert. denied,* 450 U.S. 999 (1981).

motivated by its own self-interest. Hence, they would not be considered independent and would not be protected by the business judgment rule. This issue necessarily implicates facts which are peculiarly within the knowledge of the directors—their own motives. To deal with this issue, the Delaware courts have placed the burden of going forward with the evidence on the directors to show independence and reasonable investigation.

In both *Unocal* and *Household*, the court noted that the board was composed of a majority of outside directors. The presence of this characteristic "heightened" the presumption available to the board with respect to their independence and their actions. The reasonable investigation element relates to the board's process or methodology which the courts will scrutinize very carefully in determining whether the directors examined all material facts reasonably available to them and exercised due care in decision making, or whether they were grossly negligent.[20]

In addition to "flip-over" rights plans, there are other devices. There are "back end" plans such as that involved in *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.* [21] Pursuant to such a plan, a stockholder can receive a debt security roughly approximating the "true value" of the stock, presumably above the market price. Voting plans may validly be made discriminatory against the acquiror under Delaware law in some instances. In *City Federal Savings & Loan Association v. Mann*, preferred stock which involved scaled voting, i.e., the diluting of the voting power of each share of the acquiror's stock after he had reached a certain threshold, was held to be valid under Delaware law.[22] On the other hand, other voting plans have run into problems in courts outside of Delaware, even when the court purports to apply Delaware law.[23]

While not necessarily controlling on the issue of pre-planning, the legal issues involved in lock-ups as a defensive maneuver may

---

19. *Unocal Corp.*, 493 A.2d at 955; Cheff v. Mathes, 199 A.2d 548 (Del. 1964).

20. *See Van Gorkom*, 488 A.2d at 873; Hanson Trust PLC v. SCM Acquisitions, Inc., Nos. 693, 726 (2d Cir. Jan. 6, 1986).

21. 501 A.2d 1239 (Del. Ch.), *aff'd*, Nos. 353 & 354 (Del. Nov. 1, 1985).

22. No. 84-4010 (D.N.J. Aug. 2, 1985), *aff'd*, (3d Cir. Jan. 10, 1986) (order). In reaching its decision, the district court relied upon Baker v. Providence & Worcester Co., 378 A.2d 121 (Del. 1977).

23. Asarco, Inc. v. Court, 611 F. Supp. 468 (D.N.J. 1985) (applying New Jersey law); Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985) (applying Delaware law).

be relevant in gauging the degree of a court's scrutiny. In *Revlon*, in addition to the note plan, there was a lock-up option. Neither was held to be invalid per se, but the court of chancery enjoined the lock-up option as used in that case. First, the court found that the board's concern with its duty to, and exposure to liability at the hands of, the noteholders created serious duty of loyalty problems in carrying out their fiduciary duty to the stockholders. Since the lock-up put the board in a competitive bidding situation, they had a fiduciary duty to the stockholders to negotiate for the better of the competing bids, and the lock-up did not meet that test. Second, the court noted that the defensive measures adopted by the board resulted in a substitute of the board's decision for the marketplace in implementing the devices. The court of chancery concluded that the board had thus placed itself at the "plateau of plenary negotiating authority," thus heightening its duty to shareholders. In a recent opinion, the Delaware Supreme Court affirmed the granting of the injunction.[24] Likewise, in *Hanson Trust PLC v. MLSCM Acquisition, Inc.*,[25] the Second Circuit invalidated a lock-up where the board's process was found to have been faulty, particularly in placing a substantially lower value on the lock-up than that which the court felt was reasonable.

Household, Revlon, and *SCM* all have lessons in counseling.

1. There must exist either a pending specific threat or a rational concern over general vulnerability leading to a need for protection of stockholder interests, not entrenchment. A company which unnecessarily enacts a "poison pill" or other device may be perceived as worrying about its own vulnerability and thus may attract attention to itself. Although this concern may diminish as more companies take such steps, it is necessarily a concern for some companies, particularly with respect to their relationship with institutional investors.

2. The process should include inside counsel, outside counsel, takeover specialists, investment bankers—with sufficient time and sufficient materials (including text of plans, explanatory memoranda, and summaries, etc.). The financial analysis must be based on present and long-term values as well as the relationship of the value of the stock to the underlying breakup value of the company.

3. The board should have a preponderance of outside directors

24. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

25. Nos. 693, 726 (2d Cir. Jan 6, 1986).

or, absent such a preponderance, a committee of outside directors should independently consider the proposal. A planning committee of outside directors may also be desirable.

4. The *Household* plan and its natural improvements are a reasonably safe harbor. Other rights plans which get too creative and add "draconian" provisions may take the board out of the safe harbor.[26]

5. The consequences on the future fiduciary duties of the board must be considered. As the court recognized in *Household*, the board does not have "unbridled discretion" in refusing to redeem outstanding rights. The board may be put on the spot by a conditional tender offer which is related to a demand to redeem the rights. This tactic would put considerable pressure on the board.

6. The board in granting a lock-up may end up obliged to conduct an auction. Thus, its valuation decisions and processes can be second-guessed because the board may have achieved a "plateau of plenary negotiating authority." Moreover, the board may have made itself susceptible to greenmail or may have facilitated putting the company "in play," as when an acquiror triggers the rights plan without the ability to mount a takeover bid and before negotiations can be conducted.

7. In some instances, the board may be creating additional constituencies to which it may have conflicting fiduciary duties. In *Revlon*, for example, implementation of a "back end" rights plan and an exchange offer created a new constituency—the noteholders. The conflict between the directors' perceived duty to the noteholders and the duties to the stockholders may become a problem. These issues should be considered at the outset before a plan is adopted and consideration of these topics becomes part of the methodology.

In the wake of *Household*, corporations are adopting various forms of rights plans every day. It is possible that some plans will go beyond *Household's* safe harbor. They may or may not be valid. Some provisions not found in *Household* have a better chance of being validated than others. For example, many companies have included in their rights plans so-called "self-dealing" provisions. Such provisions would tend to deter an acquiror who has "gone through the stop sign" from engaging in defined transactions or his voting power could be diluted by other shareholders. To the extent that such

---

26. *See* Minstar Acquiring Corp. v. AMF, Inc., [1984-1985 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,066 (S.D.N.Y. June 6, 1985).

provisions are reasonably drawn to deter self-dealing they should be justifiable under *Unocal*, such provisions give the board the power to deal with a perceived "bad man," one of the justifications found by the *Unocal* court in sustaining the board's discriminatory self-tender.

The law of Delaware is dynamic and the Delaware cases themselves are sometimes difficult to rationalize. Moreover, the laws of other jurisdictions or other courts applying Delaware law complicate the analysis. The standards of the defensive business judgment rule as applied in derivative suits for damages against directors seem to be intact. These standards are relatively unaffected by the takeover phenomena, although *Smith v. Van Gorkom*[27] injected a new application to one of the rubrics of the traditional principles—due care in decision-making. *Van Gorkom* implies that there will be greater scrutiny of the directors' decision-making process even in cases involving the application of the "defensive" business judgment rule. In the takeover arena, however, not only will the process be scrutinized, but substantive decisions will be examined for "reasonableness"—a concept which implies an objective determination by the court. Such a jurisprudential approach has no rightful place in the application of the defensive business judgment rule. There is a new scrutiny emerging in the application of the business judgment doctrine in transactional justification cases to defensive measures.

Recent cases purport to apply the business judgment rule and merely shift the burden of going forward with the evidence in some respects. There is a danger, however, that this approach could lead to random *ad hoc* decisions. Courts tend to be result-oriented. If a particular defensive tactic does not pass the "smell test", i.e., it looks like an effort to entrench the incumbents and that there is a reasonable likelihood that stockholders are not getting the best price obtainable, the court may employ the new standards of judicial review to justify an injunction. Anchoring these new jurisprudential approaches to the traditional business judgment doctrine is an understandable rationale, even though careful analysis may reveal distortions of concepts and application. Nevertheless, the counseling lesson is clear, whether one is advising a target or a bidder: concentrate on independence and methodology and take every reasonable step to be sure your approach passes the "smell test."

---

27. 488 A.2d 858 (Del. 1985).