THE BIRTH OF *UNOCAL*—A BRIEF HISTORY

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ABSTRACT

Justice Moore's commentary on the history of Unocal *is a first-hand account of the Delaware Supreme Court's* Unocal *decision. He provides the history of corporate takeovers prior to* Unocal, *and then takes the reader through the development of the case itself, including the history of the company, the trial court's involvement and the personalities behind the curtain. He also provides insight into how the court decided to adopt the so-called* Unocal *intermediate standard of review and he explains the essential features of the court's decision. Justice Moore concludes with how* Unocal, *along with* Moran v. Household International, Inc., *heard by the Delaware Supreme Court four days after its* Unocal *decision, forever changed hostile corporate takeovers.*

I. THE HISTORICAL CONTEXT BEFORE 1985

Hostile takeovers were nothing new to the twentieth century. With the Great Depression and World War II over, there was money to be made from taking control of companies with underperforming assets and management. Robert R. Young, whose early ties to Delaware through his work for the DuPont Company, General Motors, and as a protégé of John Jacob Raskob, the financial genius of those two companies, is a story of legend. Young made a fortune by selling short just before the 1929 stock market crash. In 1942, he acquired control of the Chesapeake and Ohio Railway Company, and later, in an epic proxy contest he gained control of the New York Central Railroad, one of the foundations of the Vanderbilt fortune.

A contemporary of Young's was Thomas Mellon Evans, a distant relation of the Pittsburgh family bearing his middle name. His life and times are described in a fascinating book written by Diana B. Henriques, a New York Times financial reporter.[1] Men like Young and Evans were

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[1] DIANA B. HENRIQUES, THE WHITE SHARKS OF WALL STREET: THOMAS MELLON EVANS AND THE ORIGINAL CORPORATE RAIDERS (Scribner 2000).

intent upon delivering value to the shareholders of the companies they acquired. Their commitment to achieving that goal is vividly described in *White Sharks*. Henriques describes Evans:

> By 1959, Tom Evans already had become the leading practitioner of a strange new form of corporate ruthlessness, one that squeezed "fat" out of profitable corporations in the relentless pursuit of greater profit. By 1968, the *Wall Street Journal* had declared Tom Evans "something of a legend for his tough methods of operating the company once he wins control. He demands prompt profit performance from both assets and men; if he doesn't get it, he sells the assets or fires the men."[2]

A. *Development of the Takeover Movement*

Starting in the 1950s, shrewd financial investors recognized that certain risks, unique to a given industry and its products, could be eliminated by concurrent investments in other industries. This gave rise to the conglomerate movement, achieved through both friendly transactions and hostile force. Up through the 1960s the usual method of friendly, and some unfriendly, acquisitions was a stock swap, requiring registration under the Securities Act of 1933. However, for most hostile takeovers, it was the proxy battle—enormously time-consuming, expensive, unpredictable, and highly regulated by the proxy rules of the Securities and Exchange Act of 1934.

B. *Some Interesting Terminology*

In the late 1950s or early 1960s, there emerged a new takeover device, the "Saturday Night Special," not an inapt term, darkly deriving its name from the cheap handguns readily available on the market, often used for weekend holdups and shootings. The "Special" succeeded with brutal efficiency, and, by using cash, rather than an exchange of securities, was unburdened by strictures of the securities laws of the United States. Takeover plans were made in great secrecy and stealth. A hostile cash tender offer would be announced, usually over a weekend, at a modest premium over market price. The offer would be limited to a certain percentage of the company's outstanding shares, sufficient to give the

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[2] *Id.* at 14.

bidder control of the target. All shares tendered up to that percentage would be bought on a first-come, first-served basis, typically in the early part of the following week. Shares tendered too late, or not at all, would not be bought, and faced a squeeze out merger after the bidder took control of the company—frequently receiving "junk" securities in payment—the classic two-tier, front-end loaded, coercive bid in "overdrive" and on steroids. Obviously, the "Special" was so successful because it placed great coercive pressure on shareholders to tender in a crush for the front-end cash payment. Caught totally by surprise, the target management was so disorganized, frightened, and demoralized that any effective resistance was unlikely, and at best, futile. In short, they were ousted in a matter of a few days. Management lacked any adequate tools to protect the company, or maximize long-term shareholder value, while hostile bidders could run rampant over such interests, buying companies cheaply, and garnering the profits for themselves.

The basic arguments in support of hostile takeovers, irrespective of how they were achieved, have always been purely economic: (1) the mere threat of a possible takeover motivates directors and managers to consistently maximize (short-term) shareholder value, or face the inevitable; and (2) when an underperforming company is taken over, the inefficiencies will be eliminated, producing a leaner, meaner enterprise, thereby restoring, or maximizing, shareholder value. This was the mantra of men like Evans and Young. It would be picked up by the free market theology of the Law and Economics movement, i.e., the conjunction of corporate law with economic theories, best exemplified by the "Chicago School," and warmly embraced by the raiders and greenmailers of the 1980s.

The term "synergy" also entered the lexicon of corporate takeovers as a euphemism for "squeezing the fat" out of a target company—expense reductions, firings, selling off assets, closing facilities, and various other forms of corporate restructuring. Thus, the synergistic financial objectives, and presumed benefits, were not without other economic and societal costs that became political rallying cries for attention and change by the 1960s. In its one foray into addressing these problems, Congress adopted the Williams Act of 1968,[3] as an amendment to Section 14 of the Securities Exchange Act of 1934,[4] to end the "Saturday Night Specials." Originally, the Act applied only to cash tender offers, which until then were unregulated. Later, it was expanded to include all tender offers.

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[3] 15 U.S.C. §§ 78m(d)-(e); 78n(d)-(f) (2001).

[4] *Id.* § 78a.

Basically, the Williams Act and the rules and regulations promulgated under it by the SEC require any person or group acquiring more than 5% of a company's stock to make certain disclosures to the company, the exchanges upon which it is traded, and the SEC. These disclosures regarding the identity of the acquirers and whether the purpose of the purchases, or prospective purchases, of the company's stock is to obtain control of the company.[5] The Act also gave the SEC increased powers to regulate tender offers, resulting in the requirements that a bid for the target company's stock remain open for ten days, later increased to twenty business days;[6] and if the offer is to acquire less than all shares, that all stock tendered into the offer be prorated, thereby eliminating the first-come, first-served crush of the old "Saturday Night Specials."[7] Another important aspect of the Act permits a tendering shareholder to withdraw tendered securities during the entire offer.[8] The Act, which was described briefly above, achieved its intended effect. The "Special" was dead. However, the ingenuity, indeed brilliance, of lawyers like Joseph Flom and Martin Lipton, and investment bankers like Bruce Wasserstein, soon proved that the Act was no panacea for countering hostile tender offers.[9] It just extended the process, and gave the target's management time to mount a defense, sometimes quite effectively.

The two-tier, front-end loaded, coercive, junk bond fueled, bust-up tender offer still retained potency, even if the Williams Act took it off

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[5]*Id.* § 78m(d)-(e).

[6]SEC Rule 14e-1.

[7]Securities Exchange Act § 14(d)(6) (2000).

[8]*Id.* § 14(d)(5); SEC Rule 14d-7.

[9]Mr. Flom was an editor of the *Harvard Law Review*, graduating *cum laude* in 1948. However, none of the established Wall Street law firms would hire him. In 1948 he joined the fledgling four-man law firm of Skadden Arps Slate & Timbers as its first associate. Because hostile takeover work was considered "beneath" the large Wall Street law firms and investment banks, Mr. Flom built a unique practice in that field, becoming the real founder of the modern day firm of Skadden, Arps, Slate, Meagher, and Flom, now one of the largest law firms in the world. Martin Lipton, although a brilliant law student and Editor-in-Chief of the *New York University Law Review*, likewise found that upon graduation from the New York University School of Law in 1955, he could not get a job with any major Wall Street law firm. Three of his other NYU classmates, all at the top of their class, faced the same closed doors. In 1965, the four of them formed the firm of Wachtell, Lipton, Rosen & Katz, one of the most successful and highly respected corporate law firms in America. Mr. Lipton's lasting fame in the world of corporate law is as the creator and inventor of the poison pill. Bruce Wasserstein graduated from Harvard University in the 1960s with combined JD and MBA degrees. Following graduation, he joined one of Wall Street's most prestigious old-line law firms as an associate working on mergers and acquisitions. This brought him in contact with investment bankers, who noted his brilliance, and convinced him to switch his career to investment banking, where he was involved in virtually every major takeover during the 1980s. Mr. Wasserstein now heads the distinguished investment banking firm, Lazard Freres.

steroids and made it follow speed limits. The tactic still included an offer to buy a certain percentage of the target's stock at a small premium above market price (sufficient to give the bidder just over 50% of the company's stock when added to the bidder's prior purchases) for cash or a major cash component, called the "front end." The bidder also announced that when the offer closed, and control was acquired, the remaining public shareholders would be eliminated in a squeeze out merger (the "back end"). The "back end" usually received highly subordinated debt securities (junk bonds) having a face value equal to the cash paid at the front end. The problem, of course, was one of valuation, since the face value of such debt securities did not necessarily reflect their actual or intrinsic worth. Thus, all the coercion of the "Special" remained, and management still had few tools at its disposal to effectively defeat such an offer.

A new aspect of the takeover game emerged in the 1970s and 1980s—greenmail. Using the technique of an investment banking letter, (for which substantial fees were paid) which assured the bidder the banker was "highly confident" of being able to provide the funds to achieve the takeover, the bidder could give the appearance of having sufficient financial resources to make a hostile offer. However, there was no commitment by the banker to actually provide the money. Nonetheless, armed with the "highly confident" letter, the raider could still unnerve management to the point of the target buying out the bidder's stock at a substantial premium, which no other shareholders received—classic 1980s greenmail.[10] Although not without criticism, the Supreme Court of Delaware implied judicial approval of greenmail, when it reversed then Vice Chancellor Marvel in *Mathes v. Cheff*,[11] permitting a company to buy out a large block of stock owned by a troublesome shareholder.[12]

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[10]As we noted in the *Unocal* opinion, "The term 'greenmail' refers to the practice of buying out a takeover bidder's stock at a premium that is not available to other shareholders in order to prevent the takeover." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 n.13 (1985).

[11]190 A.2d 524 (Del. Ch. 1963), *rev'd* Cheff v. Mathes, 199 A.2d 548 (Del. 1964).

[12]Many years later, the author discussed *Cheff* with then-Chief Judge Collins J. Seitz of the United States Court of Appeals for the Third Circuit, who prior to his appointment to the Court of Appeals in 1966, had served on the Delaware Court of Chancery for twenty years (1946 to 1966), fifteen of them as Chancellor (1951 to 1966). Despite the passage of over two decades since *Cheff*, Judge Seitz's unaltered view of the Supreme Court's decision in that case remained pithy and succinct—"Disgraceful!"

C. *Legal, Economic, and Social Considerations*

The intended effects of takeovers, however euphemistically described—"synergy," "efficiency," "unlocking hidden value," or just plain "wringing out the fat," all in the name of enhanced profits—can have enormous adverse economic and social consequences upon corporations and their constituencies, most particularly employees, employees' families, and communities. Layoffs and plant closings created a "Rust Belt" in the Midwest, where nothing replaced the lost jobs and empty factories. Unemployment, loss of pensions, communities in distress, and the black despair they produced, had little effect in causing various branches of federal and state governments to consider takeover abuses, and their resulting consequences. Some states adopted antitakeover laws in the form of "constituency statutes."[13] Generally, these statutes provided that boards of directors could consider various corporate constituencies—employees, creditors, suppliers, customers, and even the community generally, without considering the interests of shareholders, in rejecting a takeover bid. All of these came after *Unocal* and drew from its language.[14] The anomaly of such statutes is that they sanction a breach of fiduciary duty to shareholders by self-interested management seeking to entrench itself without any of the balance *Unocal* requires.

If governmental authorities paid little or no attention in the 1980s to the legal, economic, and social consequences of takeovers, one of the giants of the corporate bar, Martin Lipton, did not ignore the issues. In two seminal articles, upon which the court drew heavily in *Unocal*,[15] Mr. Lipton argued forcefully that boards of directors had both the power and duty to resist inadequate hostile bids. Moreover, in an empirical study covering the period from late 1973 to June 1979, he pointed out that of thirty-six tender offers studied, where the target defeated a hostile bid, more than half were trading at a market price higher than the hostile bid, or had been acquired by another company at a higher price than the hostile tender offer.[16] Other leading members of the corporate bar expressed similar views on a board's

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[13]Notably, New York, Pennsylvania, Ohio, Illinois, Indiana, and Connecticut. For an extensive list, see ABA Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990).

[14]*See infra* Part IV.

[15]*Unocal*, 493 A.2d at 954 n.9, 955.

[16]Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Martin Lipton & Andrew R. Brownstein, *Takeover Responses and Directors' Responsibilities: An Update*, ABA National Institute on the Dynamics of Corporate Control (Dec. 8, 1983), *reprinted in* 40 BUS. LAW. 1403 (1985).

duties to actively address, and if necessary, oppose, a hostile bid.[17] Because a tender offer by its terms is addressed, not to a board, but to a company's shareholders, the role of the board, if any, became the topic of much debate before *Unocal* arose. Opposition to the involvement of a board in the tender offer process was vigorous and scholarly. Chief among the opponents were followers of the "Chicago School" of law and economics, who believed that the Efficient Capital Markets Hypothesis (ECMH)[18] should control the tender offer process without board intervention.[19]

These polar positions of Martin Lipton and the Chicago School went to the heart of Delaware corporate law—the managerial authority of boards of directors conferred by Section 141(a) of the Delaware General Corporation Law (DGCL),[20] and the economic interests of shareholders in the marketplace. Addressing the social implications of takeovers, there later developed an important body of scholarly study as to the adverse

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[17]Dennis J. Block & Yvette Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L.J. 44 (1983); Leo Hertzel et al., *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107 (1980).

[18]The ECMH is based on the notion that "the prices of publicly traded assets, such as stocks and bonds, match the value that asset pricing theory says these assets should have." RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 135 (2d ed. 1995). The ECMH has three forms—strong, semi-strong, and weak.

> [T]he *strong* form of ECMH states that market prices are an unbiased estimate of future cash flows that fully reflects *all* information, both public and private. The strong form of ECMH is an extreme hypothesis that is not satisfied in the real world. If it were, inside trading would not be a profitable activity. The *weak* form of ECMH states that investors can't earn an above-market return by relying on the past history of stock prices and stock trading. The weak form is subsumed in the semistrong form, since past prices, and trading history are particular types of publicly available information.

Id. It is the semi-strong form, that "at any point in time, market prices *are an unbiased forecast of future cash flows that fully reflects all publicly available information*" that focused the academic debate. *Id.*

[19]Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981); Frank H. Easterbrook & Robert R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). In these pieces, the authors argued that the board's role should be a passive one. *Id.* We rejected any such notion, observing that even the authors conceded that no court or legislature had adopted it. *Unocal*, 493 A.2d at 955 n.10.

[20]That section provides in relevant part: "(a) The business and affairs of every corporation organized under this chapter shall be *managed by or under the direction of a board of directors* . . . ." DEL. CODE ANN. tit. 8, § 141(a) (2001) (emphasis added).

personal effects of such transactions on those most directly affected—employees, their families, and their communities.[21]

D. *The 1985 Political Environment*

This was the Reagan administration era (1981-1989) of *laissez faire* in thrall of the Chicago School. Obviously, nothing would be done to hinder the adherents of its tenets in control of the Securities and Exchange Commission and the Antitrust Division of the Department of Justice. Congress displayed its lack of appetite for entering the fray by doing nothing.

E. *The Legal Environment*

Coupled with the influence of the Chicago School's convergence of law and economics, in 1982 the Supreme Court of the United States invalidated the Illinois Business Take-Over Act on grounds of preemption—that the Williams Act preempted state antitakeover statutes.[22] The result was that those states, including Delaware, that had adopted various forms of antitakeover legislation found their laws invalid. It was not until two years after *Unocal* that the United States Supreme Court upheld a second-generation antitakeover statute, adopted in Indiana, on grounds that the law was neither in contravention of the Commerce Clause, nor preempted by the Williams Act.[23]

II. THE *UNOCAL* CASE

A. *Background*

The *Unocal* case[24] arose amidst a swirl of brewing historical, economic, social, political, and legal tensions that compelled

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[21]Marleen O'Connor-Felman, *American Corporate Governance and Children: Investing in Our Future Human Capital During Turbulent Times*, 77 S. CAL. L. REV. 1255 (2004); Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 COMP. LAB. L. & POL'Y J. 97 (2000); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 901 (1993); *see generally* Marleen O'Connor, *Rethinking Corporate Financial Disclosure of Human Resource Values for the Knowledge-Based Economy*, 1 U. PA. J. LAB. & EMP. L. 527 (1998) (discussing the effects of corporate decision making on human capital).

[22]Edgar v. MITE Corp., 457 U.S. 624 (1982).

[23]CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 93 (1987).

[24]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (1985).

consideration—but by whom, where, and how? Generally, courts are not the best places to resolve competing issues of such broad public policy that ideally should be addressed elsewhere.[25] Moreover, there was no well-established precedent to guide the Delaware Supreme Court in dealing with the unique legal issues in *Unocal*, and the speed with which the court was forced to hear and decide them remains today, twenty-one years later, as breathtaking and daunting as it did at the time. As the sole living member of the court who participated in deciding *Unocal*, I write this piece from my own historical vantage.

T. Boone Pickens viewed himself as an "entrepreneurial populist," but in other circles, he was labeled a corporate raider and greenmailer.[26] In 1956, Pickens founded Mesa Petroleum Company and served as its president and chairman of the board.[27] Along with other related entities controlled by Pickens (collectively Mesa), the group owned about 13% of Unocal's stock.[28] On April 8, 1985, Mesa commenced a highly coercive tender offer for approximately 37% of Unocal's outstanding stock at $54 per share.[29] If successful, Mesa would own just over 50% of Unocal stock, thereby giving Mesa control of the company.[30] At first, Mesa failed to adequately disclose what would happen to the remaining Unocal shares if Mesa gained control of Unocal through the tender offer, except that they would be acquired by an exchange of securities purportedly worth $54 a share. A federal court in California compelled fuller disclosure, and on April 26, and May 3, 1985, Mesa publicly disclosed that at such a back-end transaction, Unocal shareholders would receive highly subordinated securities, i.e., "junk," and that Unocal's capitalization would be significantly changed.[31] After much deliberation from April 13 to April 15, the Unocal board, comprised mainly of outside directors, concluded that

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[25]There is, however, a very strong view to the contrary. In their classic treatise, Adolph A. Berle and Gardiner C. Means urged (federal) judicial intervention to rectify a host of perceived corporate ills adversely affecting social and economic conditions. ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (NY: Harcourt, Brace and World 1968). This expectation preceded the case of *Erie Railroad Company v. Tompkins*, 304 U.S. 64, 78 (1938), one effect of which gave primacy to the Delaware courts in matters of their own corporate case law, thereafter producing bitter, and intellectually dishonest, criticism of Delaware's statutory law and judicial decisions applying it. *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).

[26]*See, e.g.*, *Unocal*, 493 A.2d at 956 & n.13.

[27]*Id.* at 949 n.1; T. BOONE PICKENS, BOONE 45-46 (Boston: Houghton Mifflin, 1987).

[28]*Unocal*, 493 A.2d at 949.

[29]*Id.*

[30]*Id.*

[31]*Id.* at 949-50.

Mesa's $54 offer was inadequate, and unanimously rejected it.[32] On April 17, after advice from investment bankers, Unocal countered Mesa's bid by making a self-tender for 29% of Unocal stock, except those shares held or acquired by Mesa, in exchange for debt securities having an aggregate value of $72 per share.[33] This meant that Unocal would incur over $6 billion in debt, which would necessarily curtail its exploratory drilling operations.[34] The Unocal board was advised that Unocal, nonetheless, would remain viable.[35] Unocal's bid was set to expire on May 17, 1985.[36] By its very nature such an exchange offer was not just exclusionary, but discriminatory, as to Unocal's largest stockholder, Mesa. On its face, this appeared to violate a fundamental principle of Delaware fiduciary law, prohibiting a company from discriminating against a shareholder. Unocal's rationale for the Mesa exclusion was obvious—if Mesa could tender its shares to Unocal, then Unocal would in effect be financing Mesa's own inadequate $54 bid.[37] The exchange offer was later criticized as also being coercive, because Unocal's stock would likely drop in market value well below the $72 exchange offer. Furthermore, Unocal then would have a capital structure burdened by the additional debt of over $4 billion.[38] It also meant that Mesa's Unocal shares, excluded from the exchange, likewise would lose considerable value.[39]

B. *The Trial Court's Involvement*

Mesa filed suit in the Delaware Court of Chancery on April 17, 1985, seeking to enjoin Unocal's exclusionary self-tender.[40] No court had addressed such a legal issue under similar factual circumstances. After expedited briefing, the trial court heard Mesa's application on April 26.[41] Three days later, the court of chancery temporarily restrained Unocal from making its exclusionary offer unless it included Mesa, and set a preliminary injunction hearing for May 8.[42]

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[32] *Unocal*, 493 A.2d at 950.

[33] *Id.* at 951.

[34] *Id.* at 950.

[35] *Id.*

[36] *Unocal*, 493 A.2d at 951.

[37] *Id.*

[38] Michael C. Jensen, *When Unocal Won Over Pickens, Shareholders and Society Lost*, 9 FINANCIER 50 (Nov. 1985).

[39] *Id.*

[40] *Unocal*, 493 A.2d at 951.

[41] *Id.*

[42] *Id.* at 952.

On May 1, 1985, Unocal presented an interlocutory appeal to the Delaware Supreme Court.[43] The court, however, could not determine from the limited record before it whether the parties had addressed certain issues that the vice chancellor should have had an opportunity to consider in the first instance.[44]

In view of the upcoming May 8 hearing in the court of chancery, at which there would be an expanded record, the supreme court issued an order on May 2, deferring action on the appeal, and asked the vice chancellor to consider the following four questions:[45]

1. Does the directors' duty of care to the corporation extend to protecting the corporate enterprise in good faith from perceived depredations of others, including persons who may own stock in [Unocal]?

2. Have one or more of the plaintiffs [Mesa] . . . or persons acting in concert with them [Pickens and others], either in dealing with Unocal or others, demonstrated a pattern of conduct sufficient to justify a reasonable inference by defendants [Unocal and its board] that a principle objective of the plaintiffs is to achieve selective treatment for themselves by the repurchase of their Unocal shares at a substantial premium [greenmail]?

3. If so, may the directors of Unocal in the proper exercise of business judgment employ the (discriminatory) exchange offer to protect the corporation and its shareholders from such tactics?[46]

4. If it is determined that the purpose of the exchange offer was not illegal as a matter of law, have the directors of Unocal carried their burden of showing that they acted in good faith?[47]

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[43] *Id.*

[44] *Unocal*, 493 A.2d at 952.

[45] *Id.*

[46] *See* Pogostin v. Rice, 480 A.2d 619 (Del. 1984).

[47] *See* Martin v. Am. Potash & Chem. Corp., 92 A.2d 295, 302 (Del. 1952).

In an unreported opinion on May 13, 1985, the court of chancery granted Mesa a preliminary injunction, and certified the interlocutory appeal to us. The vice chancellor also responded to our questions, as related in our formal *Unocal* opinion:

> Specifically, the trial court noted that "[t]he parties basically agree that the directors' duty of care extends to protecting the corporation from perceived harm whether it be from third parties or shareholders." The trial court also concluded in response to the second inquiry in the Supreme Court's May 2 order, that "[a]lthough the facts, . . . do not appear to be sufficient to prove that Mesa's principle objective is to be bought off at a substantial premium, they do justify a reasonable inference to the same effect."
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> As to the third and fourth questions posed by this Court, the Vice Chancellor stated that they "appear to raise the more fundamental issue of whether directors owe fiduciary duties to shareholders who they perceive to be acting contrary to the best interests of the corporation as a whole." While determining that the directors' decision to oppose Mesa's tender offer was made in a good faith belief that the Mesa proposal was inadequate, the [trial] court stated that the business judgment rule does not apply to a selective exchange offer such as this.[48]

Clearly, the legal issue was a matter of first impression: the power of Unocal's board of directors to adopt such a novel defensive measure against Mesa Petroleum, a minority shareholder making a hostile, coercive, undervalued bid for control of Unocal.[49] That was the surface issue—can a Delaware company discriminate against one of its shareholders in favor of the rest? Standing alone, it had enormous corporate governance policy implications. In the background, however, there also lurked some very significant social, economic, and political ramifications that were better addressed elsewhere, but upon which any decision we might make would have some bearing—a highly uncomfortable position for a court under any circumstances.

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[48] *Unocal*, 493 A.2d at 952-53.

[49] *Id.* at 953.

C. *The Personalities Behind the Curtain*

It is interesting to note in retrospect that the litigation perhaps was driven as much by some sharp personality clashes between the contending parties as it was by the declarations of "principle" that each side strongly, and publicly, espoused. I now suspect that the former had as much to do with the way the case developed, and ultimately landed on our doorstep, as did the bare unique questions of law we were asked to decide.

Here is some of the flavor of the parties and their views of each other. Unocal, with its headquarters outside of Los Angeles, was the successor to Union Oil Company of California, founded in 1890. Its CEO was a crusty, hard-bitten, oilman, Fred L. Hartley, who had spent his career at Unocal. In 1985, he was seventy years old, beyond normal retirement age, and had no designated successor. He harbored deep suspicions that New York law firms were too closely allied with investment bankers to be trusted, and he would have nothing to do with them in a fight for corporate control.[50] It appears that Unocal and Hartley cared little for their public image. In 1969, a natural gas blowout occurred on a Unocal platform located six miles off the coast of Santa Barbara, spreading 200,000 gallons of crude oil to the surface, and creating an 800 square mile oil slick, which contaminated thirty-five miles of coastline, creating extensive ecological damage to beaches and wildlife. In answer to environmental complaints, Mr. Hartley's public response was: "I don't like to call it a disaster [because there was no loss of human life.] I am amazed at the publicity for the loss of a few birds."[51]

In the 1980s Mr. Hartley also harbored a strong personal antipathy toward corporate raiders, like Mr. Pickens, who had made several unsuccessful attempts to take control of oil companies many times the size of Mesa, and "greenmailed" them into making him go away, i.e., "the practice of buying out a takeover bidder's stock at a premium that is not available to other shareholders."[52] In 1982, Mr. Pickens attempted to seize control of Cities Service Company; then Gulf Oil Corporation in 1983; Philips Petroleum Company in early 1985; and shortly thereafter, Unocal in April 1985.[53] The stated reasons for such takeover efforts generally fell

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[50]As a result, Unocal was represented by two California-based firms, and the Wilmington firm of Morris, Nichols, Arsht & Tunnell. On the other hand, Mesa appeared to be represented only by the Wilmington firm of Richards, Layton & Finger. In fact, Joseph Flom of Skadden, Arps, Slate, Meagher, & Flom also was quietly advising Mr. Pickens and Mesa.

[51]Santa Barbara Wildlife Care Network, *available at* http://www.sbwcn.org/spill.shtml.

[52]*Unocal*, 495 A.2d at 956 n.13.

[53]PICKENS, *supra* note 27, at 149-70, 181, 218-35, & 244-45.

into two categories: fossilized or incompetent management, and the resulting need to unlock value for the benefit of shareholders—something that incumbent managements either could not, or stubbornly would not do.[54] Mr. Hartley railed against takeovers as diverting the target companies from their proper business and profit objectives, all to their detriment, and that of their shareholders.

For his part, Mr. Pickens seems to have had little or no respect for Hartley.[55] Each made public speeches in support of their respective positions, including testimony before Congress. In early April 1985, when it was apparent that Pickens would make a play for Unocal, the two evidently met by chance as they waited to testify at a congressional hearing on recent hostile bids for major oil companies. It was reported that Pickens extended his hand to Hartley, who refused it, saying, "Go away."[56] Pickens said, "Fred, you are talking to your largest stockholder," to which Hartley replied, "Isn't that a shame."[57]

I do not believe that any of us on the supreme court were aware of those deep currents of hostility between Hartley and Pickens at the time the *Unocal* case was before us, and in any event, they would not have had any bearing on our consideration and decision of the matter.

III. THE DELAWARE SUPREME COURT'S TAKEOVER

A. *Background*

Expedition was required by the sheer force of marketplace demands.[58] We accepted the appeal on May 14, 1985; received the parties' briefs on May 15; heard argument on May 16; and announced our oral decision from the bench at 9 a.m. on May 17.[59] Our formal written opinion followed on June 10, 1985. Thus, from start to finish the case consumed twenty-seven days in the Supreme Court of Delaware.

Only Justice McNeilly and I were able to hear the *Unocal* case. For various reasons, Chief Justice Herrmann, Justice Horsey, and Justice Christie were disqualified. Thus, to fill the required panel of three, Judge Clarence W. Taylor of the Delaware Superior Court was designated to sit

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[54] *Id.*

[55] *Id.* at 219-21.

[56] James R. Norman & Barbara Starr, *The Pickens Vise Tightens Around Unocal*, BUS. WK. (Apr. 15, 1985), at 45.

[57] *Id.*

[58] *Unocal*, 493 A.2d at 953 n.5.

[59] *Id.*

with us. He was an able and collegial colleague. Even though the schedule was very tight, with complex issues requiring an immediate decision under intense pressure of the circumstances, we nonetheless adhered to our usual practice of not discussing a pending case with each other before oral argument. Each of us, however, worked closely with our law clerks, exchanging ideas, testing our thoughts, and trying to grapple with solutions we needed to reach. It was mentally stimulating and physically trying in an atmosphere that our law clerks loved and embraced.

In accepting the appeal, even under the very intense time constraints we faced, we recognized two vital points that we had to address. First, we had to address the role of the board in hostile tender offers. As previously mentioned, a tender offer is addressed directly to the shareholders, and over the heads of the directors. Therefore, did a board have any right to interject itself in matters that were directly between an outside party and the company's stockholders? Second, if we determined that the board had a role in the process, what was it, and what standards applied to the board's actions? While there were some signposts to guide us, in other respects we were operating in virgin territory.

On Thursday morning, May 16, 1985, we assembled in the large, lofty, and historic Courtroom 1 of the Wilmington Courthouse to hear oral argument. Although the court normally sat in Dover, the State capital, it was more convenient under the pressing circumstances to hold the argument in Wilmington. While the hearing was tape recorded, it was not televised live, nationwide, as occurred in the later cases of *Time-Warner*,[60] and *QVC-Paramount*.[61] Each side had an hour, rather than the usual thirty minutes, to present their arguments. Counsel did an excellent job, facing numerous questions from the bench. Unfortunately, the issues were presented in a very polarized fashion. Unocal argued that the board not only had the authority to act as it did, but such board action should be judged simply by the traditional business judgment rule as then articulated by the court.[62] If we adopted this approach with regard to takeover defenses, then we effectively "bulletproofed" Unocal from any takeover

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[60]Paramount Commc'ns, Inc. v. Time, Inc., [1989 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,514 (Del. Ch. July 14, 1989), *reprinted in* 15 DEL. J. CORP. L. 700 (1990), *aff'd*, 571 A.2d 1140 (Del. 1990).

[61]QVC Network Inc. v. Paramount Commc'ns Inc., 635 A.2d 1245 (Del. Ch. 1993), *aff'd*, 637 A.2d 34 (Del. 1994).

[62]The traditional business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). The burden is on the challenger to prove otherwise. *Id.*

bid, even if it was advantageous to the shareholders and fair from a financial point of view.

On the other hand, Mesa's position was that defensive measures, generally, and the self-tender, specifically, were violations of the duty of loyalty, thereby requiring rigorous application of the fairness standard, placing the burden on the directors to prove the propriety of their defensive actions.[63] Such a test seemed unduly restrictive, particularly in the context of an independent board, consisting of a majority of outside directors, taking defensive actions, the essential purpose of which was to protect the company and shareholders from a potentially undervalued, coercive, hostile bid. There also was Mesa's lurking threat of greenmail, as the court of chancery observed: "Mesa has made tremendous profits from its takeover activities although in the past few years it has not been successful in acquiring any of the target companies on an unfriendly basis."[64]

Moreover, the vice chancellor "specifically found that the actions of the Unocal board were taken in good faith to eliminate both the inadequacies of [Mesa's] tender offer, and to forestall the payment of 'greenmail.'"[65] The anomaly was that instead of paying greenmail to Mesa, which would exclude other shareholders from receiving a similar benefit, the exchange offer specifically excluded Mesa from receiving any premium on its stock, while paying it to all other shareholders—a sort of reverse greenmail.

B. *The Decision*

At the close of the argument, Justice McNeilly stated that the court was taking the matter under advisement, and would reconvene the following morning (before the opening of the New York Stock Exchange)

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[63] "The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the *burden* of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts." Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (emphasis added). As further stated in *Weinberger*:

> The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors . . . were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.

Id. at 711.

[64] *Unocal*, 493 A.2d at 956 n.13.

[65] *Id.*

to announce our decision.[66] We recessed and retired to a conference room in the courthouse to deliberate. Each member of the panel stated his views in order of seniority—Justice McNeilly first and ending with Judge Taylor. It was quickly apparent that we were unanimous, not only as to the outcome, reversal of the court of chancery, but also as to our rationale.

We had little difficulty with the question of the board's active role in the process, indeed its duty to act, for two basic reasons. The first reason was the paramount responsibility of the board to manage the "business and affairs" of the corporation conferred by section 141(a) of the DGCL. To suggest that the board must refrain from any action when a takeover bid occurred, however coercive and inadequate, struck us as ignoring the realities of corporate law, life, and governance. The second reason was the concomitant fiduciary duties of loyalty and care that arose from the managerial powers and responsibilities, conferred by section 141(a), to protect the interests of the company and its shareholders. There was ample authority in both Delaware and federal cases for board action under such circumstances.[67] Thus, we were convinced that there was no requirement of "self-sacrifice" by a corporation and its shareholders to refrain from action thwarting conduct detrimental to their interests, even when posed by another stockholder.[68] We were familiar with the contending views of the law and economics movement versus those of practitioners like Martin Lipton, but we could not accept the Chicago School's notion of passivity by a board in a takeover context. Such a position only exposed a company and its stockholders to raiders who employed coercive tactics to acquire control with cheap, undervalued, bids. In the jargon of the financial community, that left companies and their stockholders naked in the street ready to be flattened by a steamroller. However articulated, the basic idea of the Chicago School's thesis under the semi-strong form of the ECMH, that the value of a company is its market capitalization (number of shares

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[66]In those days we still adhered to the rather naïve view that important trading only occurred on the NYSE, and our decisions affecting stock values should not be released while the exchange was open, thus ignoring the global nature of electronic trading that existed even back in 1985.

[67]Pogostin v. Rice, 480 A.2d 619 (Del. 1984); Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964); Bennett v. Propp, 187 A.2d 405, 409 (Del. 1962); Martin v. Am. Potash & Chem. Corp., 92 A.2d 295, 302 (Del. 1952); Kaplan v. Goldsamt, 380 A.2d 556, 568-69 (Del. Ch. 1977); Kors v. Carey, 158 A.2d 136, 140-41 (Del. Ch. 1960). Federal courts also reached similar conclusions. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 297 (7th Cir. 1981); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 701-02 (2d Cir. 1980); Heit v. Baird, 567 F.2d 1157, 1161 (1st Cir. 1977); Nw. Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (M.D. Ill. 1969).

[68]*Unocal*, 493 A.2d at 958.

outstanding multiplied by their market price), a simplistic math calculation, had been rejected earlier in 1985 by the Supreme Court of Delaware.[69]

Nor were we deterred by the argument that the defensive self-tender exchange offer, excluding the bidder, was invalid because nothing in the case law or DGCL permitted it. That argument ignored an underlying principle of Delaware corporate law, that merely because the DGCL is silent as to a matter does not mean it is prohibited.[70] The perplexing problems we faced were (1) the validity of this unique defense, and (2) if valid, the standard by which the conduct of directors would be judged when adopting it, and defensive measures generally. The United States Courts of Appeal for the Second and Third Circuits had applied the traditional business judgment rule to such circumstances.[71] To us, that was bulletproofing Unocal, even from a fair bid. The straightforward application of the traditional business judgment rule, accompanied by its presumptions of propriety, which a challenger has the burden to overcome, did not seem appropriate in a takeover contest. Conferring such power on a board, with little or no accountability, was a serious problem. That only opened the door to entrenchment of incumbent management at target companies.

On the other hand, rigorous application of the fairness standard, by placing the burden on the board, a majority of whom were outside independent directors, to justify non-self-interested actions taken for the benefit of the company and its stockholders, hardly seemed appropriate. Mesa's argument was that any defensive action was born of self-interest, because the board in reality was intent on saving their jobs at the shareholders' expense. That a majority of outside independent directors had adopted a defensive measure, and that, as stockholders, they had tendered their shares into the exchange offer, did not, in our opinion, make them per se self-interested, requiring invocation of the fairness standard. Here, the court of chancery specifically found that the board, consisting of a majority of independent outside directors, concluded in good faith that it had reasonable grounds for believing that Mesa posed a threat to Unocal's corporate policy and effectiveness.[72] That finding by the court of chancery,

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[69]"[A] publicly-traded stock price is solely a measure of a minority position and, thus, market price represents only the value of a single share." Smith v. Van Gorkom, 488 A.2d 858, 876 (Del. 1985). It is not a simple basis for determining the intrinsic value of a corporation as a going concern, which includes the control value associated with the enterprise.

[70]*Unocal*, 493 A.2d at 957; Providence & Worcester Co. v. Baker, 378 A.2d 121, 123 (Del. 1977).

[71]Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 702 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287, 293 (3d Cir. 1980).

[72]*Unocal*, 493 A.2d at 956 n.13, 959.

in itself, absolved the board of any taint of self-interest. Indeed, there was ample Delaware authority to this effect.[73] Nonetheless, because of the inherent danger of self-interest, when a board adopts defensive measures, we concluded that a new intermediate standard was appropriate in judging such action.[74]

Thus was born in concept the so-called *Unocal* intermediate standard, which no other court had adopted, or apparently even considered. Having taken careful notes of our discussions in conference, Justice McNeilly asked me to draft a preliminary decision that I was to read from the bench the next morning. I immediately returned to my office in the Wilmington Supreme Court chambers a few blocks away, and based on my notes began dictating a draft bench decision. After numerous revisions, it consisted of twelve typewritten pages, incorporating all of the views we discussed in conference following the argument, which I then circulated to Justice McNeilly and Judge Taylor at about 5 p.m. They promptly gave me their helpful comments and suggestions, which I included in the draft. Nonetheless, it was still rough, and only later would be refined in our formal opinion issued on June 10, 1985. Its ultimate effect, later coupled with the poison pill, killed the two-tier, front-end, coercive, loaded tender offer.

The essential features of the *Unocal* decision are (1) an intermediate standard of review between the traditional business judgment rule and the fairness test; and (2) that there must be balance in the adoption and use of defensive measures, such that they are "reasonable in relation to the threat posed."[75] Because of the "omnipresent specter" of entrenchment presented by defensive measures, we adopted the enhanced scrutiny requirement of the intermediate standard, which "calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."[76] Directors meet that obligation by showing good faith and reasonable investigation that the bidder poses a threat to the best interests of the corporation and its stockholders. We also noted that the directors' decision is "materially enhanced" when the action is by a board comprised of a majority of outside independent directors, who have acted in

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[73]*See supra* note 67.

[74]Justice McNeilly and I also knew that in five days, on May 21, 1985, we were on the panel with then Justice Christie to hear the post-trial appeal of the poison pill case, *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985), and that anything we decided in *Unocal* would affect the outcome in *Household*. Since *Moran* was not an expedited case, we had begun preparing for it well before *Unocal* arose as an interlocutory appeal, but because of the circumstances related earlier, *Unocal* had to be decided immediately.

[75]*Unocal*, 493 A.2d at 955.

[76]*Id.* at 954.

accordance with the foregoing requirements.[77] The element of balance "entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise."[78] Many examples of Martin Lipton's suggestions are listed as factors for board consideration: "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of non-consummation, and the quality of securities being offered in the exchange."[79] An effect of validating Unocal's defensive action was to invalidate coercive tactics of the kind Mesa employed, thereby giving boards of directors wide authority and discretion to deal with them. This became more significant once we approved the poison pill in *Household*.[80] These were new principles thrown into the vortex of takeover battles. To us they were essential to addressing basic concepts of corporation and shareholder welfare—and they seem to have withstood the test of time.

IV. EPILOGUE

On Tuesday afternoon, May 21, 1985, four days after deciding *Unocal*, we heard oral argument in the poison pill case, *Moran v. Household International, Inc.*, as part of our normal Tuesday oral argument day in Dover. However, to accommodate the large crowd attending, rather than using our own smaller courtroom in the supreme court building, we convened in the old supreme court courtroom located in the county courthouse on "The Green." The Green is a bucolic square, which is the heart of "Old" Dover, dating back to pre-revolutionary times. Normally, one can stand on the Dover Green and almost feel transported back to those historic days—but not on that particular Tuesday. The streets surrounding The Green were clogged with stretch limousines, giving it the appearance of some out-of-place, unsavory, gathering. After the argument, Justices McNeilly, Christie, and I returned to our conference room in the supreme court building. We were in immediate agreement that the pill was a lawful device and that its adoption and use would be governed by the *Unocal* standards. Justice McNeilly, as senior member of the panel, assigned the *Household* opinion to himself. There was much speculation that the six month delay between the argument on May 21 and issuance of the opinion on November 19 reflected problems among us in deciding the case.

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[77] *Id.*

[78] *Id.* at 955.

[79] *Unocal*, 493 A.2d at 955.

[80] Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985).

However, that was never the situation, nor did it reflect on Justice McNeilly's attention to the matter, but that is a story for another day. We do, however, now know that the delay caused great anxiety among the parties and their counsel, leading to a great deal of wild speculation. With our approval of the pill, Martin Lipton's ingenious conception, hostile takeovers, or the threat of them, were forever changed.

The various oil companies that Mr. Pickens unsuccessfully sought to control—Unocal, Philips, Gulf, and Cities Service—no longer exist as such. They have either been acquired or merged in ways that have changed them from the entities they were in the 1980s. After *Unocal* and *Household*, Mr. Pickens barnstormed across the country on behalf of the United Shareholders Association, an organization he formed, speaking to state legislatures, and any other audiences he could find, deriding such defensive measures. At Mr. Pickens' urging, the SEC adopted the "All Holders Rule," which supposedly invalidated the *Unocal* exclusionary self-tender, requiring that an offer be open to all holders of stock in a target corporation.[81] Because the SEC's powers under the Securities Exchange Act of 1934 relate to disclosure, and not the adoption of substantive principles of corporate law, the rule is arguably invalid.[82] However, that issue is moot since the poison pill is the major defensive weapon of choice in resisting a hostile bid, and *Unocal* controls both its adoption and use.

Ironically, in 1995, Mesa itself became the subject of a hostile takeover bid from Mr. Pickens' former protégé, David Batchelder. Mr. Pickens became such an adherent to the virtues of the poison pill that he was sued because the Mesa pill was viewed as so Draconian. It had a low 10% "trigger," and was claimed to discourage proxy contests.[83] So much for all that earlier Pickens pious posturing! In November 1996, Mesa was on the brink of bankruptcy, and Mr. Pickens relinquished control to another investor. Today, he trades in water rights and is chairman of BP Capital Management, a hedge fund.

In 1988, Mr. Hartley was forced to retire from Unocal. He died in 1990.

Since *Unocal*, over half of the states have enacted "constituency statutes."[84] While following the rubric of *Unocal*, authorizing directors to

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[81] 17 C.F.R. § 240.14d-10(a)(1) (2006).

[82] *See, e.g.*, Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (invalidating the "one share one vote" requirement adopted by the SEC (Rule 19c-4), where the court also noted the "murky area" between substance and procedure presented by § 14 of the Williams Act).

[83] *Company News; Disgruntled Shareholders Sue Mesa and Pickens*, N.Y. TIMES, Aug. 9, 1995.

[84] *See supra* note 13.

take the interests of various constituencies into consideration when adopting defensive measures, at least two states, Indiana[85] and Pennsylvania,[86] permit directors to subvert or disregard stockholder interests in favor of other constituencies. Pursuant to its responsibilities respecting the Revised Model Business Corporation Act, the Committee on Corporate Laws of the American Bar Association, reflecting on constituency statutes, stated:

> The Committee has concluded that permitting—much less requiring directors—to consider [other] interests without relating such consideration in an appropriate fashion to shareholder welfare [as in the *Unocal* holding, and cases following it] would conflict with directors' responsibility to shareholders and could undermine the effectiveness of the system that has made the corporation an efficient device for the creation of jobs and wealth.
>
> The Committee believes that the better interpretation of these statutes, and one that avoids such consequences, is that they confirm what the common law has been: directors may take into account the interests of other constituencies but only as and to the extent that the directors are acting in the best interests, long as well as short term, of the shareholders and the corporation.[87]

The Corporate Governance Project of the American Law Institute adopted a similar interpretation.[88] Plainly, this is the law of Delaware, requiring some "rationally related benefit accruing to the stockholders" when assessing the interests of various corporate constituencies.[89] In all, a very proud legacy for Delaware corporate law.

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[85]IND. CODE § 23-1-35-1(g) (1999).

[86]15 PA. CONST. STAT. § 515(a) (2006).

[87]Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2268-69 (1990).

[88]AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSES AND RECOMMENDATIONS, Commentary to § 6.02 (1994).

[89]Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986).