THE ROLES OF THE DELAWARE COURTS IN MERGER AND ACQUISITION LITIGATION

Speech presented at the 4th Annual Mergers and Acquisitions
Insight Information Co.

June 18, 2001

BY E. NORMAN VEASEY*

The plural usage of the word "roles" in this title is not a "typo." The Court of Chancery is a trial court with expertise in corporation law and the Supreme Court is the appellate court with expertise in corporation law. In that sense the roles of the two courts are similar.

But the roles differ in an important practical respect: Both Courts apply the law to the facts. But the Supreme Court must provide the jurisprudential policy framework, while the Court of Chancery must try to understand and apply that policy on a daily basis to a large number of cases with complex facts, variable procedural settings and often with lightning speed. Interestingly, the vast majority of these cases end in the Court of Chancery and an appeal to the Supreme Court is usually not pursued. Why?

Is it because the Court of Chancery is that good? Yes! Is it because of the economics of transactions and time-sensitivity dictate that the parties must move on? Yes!

The year 1985 was a watershed in Delaware corporate jurisprudence. At the height of the takeover era the Delaware Court of Chancery and the Supreme Court found themselves trying to navigate through a ferocious tempest of mergers and acquisitions. The high velocity winds of the economics of these transactions were swirling around time-honored jurisprudential concepts of fiduciary duty of directors. Change was in the air! The stability of the anchor chain of the business judgment rule was severely strained.

It was in this context that the year 1985 opened with the January 28th release of the Supreme Court's split decision in *Smith v. Van Gorkom*. This case was followed in rapid succession that year by four other Supreme Court cases that were to shape the mergers and acquisitions landscape—and thus the corporate governance landscape—for years to come. We all know those cases—*Rosenblatt v. Getty*, *Unocal*, *Revlon*, and *Household*. So I will not dwell on these cases.

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*Chief Justice, Delaware Supreme Court.

To be understood as fixtures in our jurisprudence, one must focus on the complex facts of these cases. They were not—and their progeny were not—"garden variety" cases involving ongoing "enterprise" decisions of a board of directors. They were takeover cases decided in the milieu of the jurisprudential dynamics of the takeover era. As takeover cases, they involved "ownership" decisions of the board, as distinct from "enterprise" decisions. And the denouèment of these cases set new standards of conduct for directors and invited new standards of judicial review.

But first I should explicate briefly some of the terms I am using:

- Enterprise decisions
- Ownership decisions
- Standard of conduct
- Standard of review

The terms "enterprise" and "ownership" decisions of directors are borrowed from a distinguished New York lawyer and former Stanford Law School Dean, Bayless Manning. His thesis—with which I agree—is that directors make (or often delegate) "enterprise" decisions—routine, ongoing, business decisions on matters like new products, plant location, plant closings, executive compensation, layoffs, etc.

The "ownership" decisions are those that affect directly the interests of stockholders. Some of these may come in corporate mid-life, such as important charter amendments or voting rights. But one most often associates the ownership decisions with an end-period event such as a merger or sale of the company.

Consciously or subconsciously the judicial antennae and sensitivity are aroused when a court is called on to review an ownership decision. How one characterizes that review (is it "scrutiny," for example?), and who should have which burden of proof and when is a complicated and fact-intensive analysis that is best left to another day.

The concepts of "standard of conduct" and "standard of review" are borrowed from Professor Melvin Eisenberg and from the last revision of the Model Business Corporation Act. I will try to paraphrase Professor Eisenberg's thesis, which, I believe, makes perfect sense: A standard of conduct states how a director *should* carry out her role as a director. A standard of review is the test a court should apply in reviewing the director's conduct to determine personal liability or to grant injunctive relief.

These general principles are just that—general. Most scholars would say that Delaware should not go to a mandatory or codified system. A rational corporation law/corporate governance regime depends on a rich body of case law and the expertise, prompt service, independence, and trust in the Delaware Court of Chancery and the Supreme Court.

The overarching philosophical issue has to do with the best economic interests of stockholders. Directors will tend to be risk-averse if they must

assume a high degree of personal risk relating to *ex post* claims of derivative liability for corporate loss resulting from a business decision gone bad. Directors need not worry under our law for mistakes of judgment—even "stupid" ones.

Modern and enlightened corporation law driven primarily by judicial decisions is a remarkable vehicle in our jurisprudence. There is a significant self-governing aspect to the corporation law in that daily functions of the enterprise are based largely on norms—i.e., non-legally enforceable governance mechanisms. Self-governance works for the most part because of the sensitivity of directors to do what is right, what is professional, what is honorable, and what is profitable. There are also negative motivators such as peer pressure, "shaming" and fear of lawsuits.

I think the quest for best practices goes on even though personal liability of directors for gross negligence is probably not a practical worry for directors because of section 102(b)(7), section 141(e), indemnification, and insurance.

Perhaps it is a cost-benefit analysis that best explains the structure of the Delaware law applied to corporate transactions—that is, the manner in which the courts have defined the fiduciary duty of care and the duty of loyalty. Law in this context should take the form of coherent and stable principles driving fact-intensive decisions because the corporation law must handle a wide variety of conduct. As a result, it is impracticable—and I believe costly—to devise a bright-line regulatory scheme that could (1) adequately cover the vast corporate landscape, (2) prevent circumvention by unscrupulous actors, and (3) keep pace with changes in corporate governance, the dynamics of economic transactions, takeover strategies and defenses, and financial devices.

The fact-intensive aspect of Delaware corporate jurisprudence is well-illustrated by cases involving the spectrum of modern mergers and acquisition cases. The Court of Chancery on a regular and urgent basis undertakes to apply the sometimes incompletely developed legal principles articulated in the occasional Delaware Supreme Court decisions in the area.

Why are these principles incompletely developed? The main reason that not all jurisprudential principles are fully developed by the Supreme Court is because most cases stop in the Court of Chancery so the Supreme Court doesn't regularly get a chance to pronounce new principles. Given the small percentage of Chancery's busy docket that is appealed to the Supreme Court, it naturally falls to the Chancellor and Vice Chancellors to make most of the law in the corporate area. And they do a superb job.

As long as we have judge-made law as the core of Delaware's corporate law system, we must focus on ways to improve the reliance of investors and courts on board of directors operating with integrity at the

heart of that system. Therefore as standards of conduct, we need to seek aspirational norms for good or best corporate practices.

Best practices is the current cultural norm, and I attribute much of that to good counseling. I would always advise counsel for the parties to identify the safe harbors and then the clients can make the risk assessment and decide on particular transactions. Usually if the clients stay within a safe harbor they need not worry. But the economics or the exigencies of a given transaction may require boards to consider pushing the envelope beyond the safe harbors.

Practitioners advising the highest standards of conduct should not—in most cases—fear a harsh standard of review. For example, counsel should assume, only as a working hypothesis, in a particular matter that the court may not apply the deferential business judgment rule to your transaction but might apply a more searching reasonableness or fairness scrutiny. Will your client's business decisions pass that test? If that is problematic, you simply lay out the risks and the client decides.

Good examples of advice can be found in law firm memos distributed to clients and others like the Wachtel, Lipton general advice letters. For example, in analyzing three of last year's Delaware decisions, the Wachtel letters said:

1. The [Chancery] decision in *McKesson/HBOC* thus reinforces many of the traditional themes of Delaware law—deference to the business judgment of directors, protection for directors who properly rely on independent experts, avoidance of crude hindsight judgments, and careful scrutiny of a board's response once clear "red flags" arise and apparent problems need to be addressed at the board level. The ruling signals that, while Delaware will continue to allow shareholders to pursue genuine claims arising out of directors' actual knowledge of wrongdoing (or "gross negligence" in failing to oversee), Delaware will not second-guess the good faith decisions of directors who approve an acquisition based on expert advice and appropriate board process. *McKesson/HBOC* is a timely reminder that thoughtfulness and good process are as important from an acquiring board's perspective as from a seller's.

2. [The Delaware Supreme Court decision in] *McMullin* [*ARCO Chemical*] represents a further example of the Delaware courts' concern that the rights of public minority shareholders be somehow protected when a control shareholder causes a cash-out transaction to occur, even when the control person is not affiliated with the buyer and there has been arm's-length negotiation. In such situations, if, as in *McMullin*, no special committee is appointed to represent the

interests of the public, it will apparently be relatively easy for a shareholder complaint to survive a motion to dismiss in Delaware if the plaintiffs can plausibly allege that the interests of the parent diverge from those of the public. Corporations involved in such potential transactions can reduce the risks of litigation, however, by thoughtful structuring of the process to protect public minorities while recognizing (as the *McMullin* opinion does itself) the business realities that are present when a majority shareholder is determined to exit.

3. The [Chancery] *Digex* decision, like the *ARCO Chemical* case, shows the continuing zeal of the Delaware courts in strictly scrutinizing the process by which transactions involving a majority shareholder occur. Where the evidence appears to show that negotiating leverage for the public minority exists but has not been tested in discussions with the buyer, the courts will be skeptical that the result is fair. Parties contemplating transactions involving a controlled company should accordingly engage in thoughtful planning of an appropriate process, and consider how representatives of a public minority can play a constructive role in the evolution of a deal that recognizes the legitimate interests of both majority and minority shareholders.

These "client letters" are merely examples of how good counselors analyze and advise boards on the application of Delaware cases when they are in the process of corporate planning.

This brings me to an interesting "current event" that bears on jurisprudence and corporate planning. There is, in the public domain, a scholarly and thoughtful paper authored by former Chancellor, now NYU Professor, William T. Allen and sitting Vice Chancellors Jack B. Jacobs and Leo E. Strine, Jr., entitled "Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law." That paper was mentioned, and criticized, in an article by Floyd Norris in the *New York Times* last Friday, June 15, 2001. The headline of Mr. Norris' article asks: "Will 'Business Judgment' Rule Again in Delaware Courts?"

Mr. Norris suggests that the Allen-Jacobs-Strine thesis could hurt the protection of stockholder interests now in place in Delaware Supreme Court jurisprudence. Mr. Norris notes, correctly, that "Delaware decisions have led boards to be careful about protecting minority shareholders." Then he laments: "Now come two sitting judges with what amounts to an invitation to companies to test the law again, perhaps by pushing through a takeover by an insider when there is a possibility, or even a certainty, that someone else might pay more. At least," he says, "what was settled law in Delaware

is now uncertain." He concludes that this notion "received a warm reception" from me and that "shareholders have reason to worry."

I suppose one could conceivably read the Allen-Jacobs-Strine article and reach the same conclusion as Mr. Norris. But I did not read the article that way. Moreover, my comments about their article have consistently been quite neutral. I read the paper—whatever one may think about sitting judges expressing these views—as an academic discourse on the jurisprudence of the corporation law. The authors suggest that our jurisprudence could use "a few mid-course corrections" and some "doctrinal pruning" in order to "avoid needless complexity." As for the propriety of these sitting judges writing the article with now Professor Allen: It is not a violation of the Canons of Judicial Ethics, in my view. But it is a bit surprising.

In discussing the complexity of the various standards of judicial review the authors examine five Supreme Court decisions: (*Smith v. Van Gorkom*; *Cede v. Technicolor*; *Kahn v. Lynch*; *Unocal* and *Unitrin*) and one Chancery decision—Chancellor Allen's own decision in *Blasius*. In analyzing these decisions the authors "propose a simplified set of . . . review standards that, because they are functional, would better serve their intended policy goals."

Although I was relieved to note that the authors did not seem to have a problem with decisions I had authored or concurred in, their primary criticism focuses on cases in which I was not involved. Maybe they were being polite to me. I have not, however, discussed the merits of their critique with the other Justices. I agree with the authors when they state in their article, "The almost infinite potential variation in the fact patterns calling for director decisions, the disparate time frames within which different boards may be required to act, and the divergent skills and information needed to make particular business decisions usually make it impossible for courts to articulate *ex ante* precise guidelines for appropriate fiduciary action in future cases."

But nothing I have said either to Mr. Norris or to the Delaware Bar Association seminar that he references in his article can be seen as a "warm reception" or can be construed as either (1) agreeing or disagreeing that any particular Delaware Supreme Court decision was poorly worded or wrongly decided; or (2) that it would be good policy to turn back the clock of protecting the economic interests of investors and to let corporate managers run roughshod over those interests (which I do not think the article proposes).

I reviewed my notes from the Delaware Bar Association seminar in talking to Mr. Norris, and I repeated to him what I said in the seminar about the judicial process truism of appellate decisions and the overarching policy that I believe the Delaware Supreme Court applies in all its decisions

particularly on fiduciary duty principles, aspirations for best corporate practices and the standards of judicial review.

First, the judicial process truism is that courts sit like clams in the water. We decide one case at a time in the context of its factual setting and the procedural posture in which those facts are presented to the court for judicial review. We do not reach out to make jurisprudential pronouncements *ex cathedra* and we do not gratuitously offer our critique of decisions of our court or any other courts. We express any such critique not in an article or essay, but only as part of a reasoned decision in a particular case if that critique is relevant and necessary to the case before us.

To paraphrase Justice Jackson decades ago: The Supreme Court is *not final* because we are right. We are right because we are *final.*

Second, as to policy or philosophy, the view I expressed is that the courts must strive to achieve the following in our decision making:

1. Coherence—economically and analytically
2. Workable doctrines
3. Prompt decisions
4. Encourage best practices by boards of directors
5. Encourage directorial risk-taking
6. Discourage self-dealing
7. Achieve stability and predictability for the benefit of corporate planners and trial courts.

I agree, therefore, with the observation of the authors that the post-1985 "era in Delaware corporation law produced generally efficient but not perfect results." These "generally efficient results" can be seen in the fact that most corporate planners and the Chancery Judges understand and can apply our jurisprudence. As the examples of client letters show the "imperfections" are a function of the case-by-case applications by this appellate court whose composition of Justices changes over the years.

Perhaps—and this is for others to judge—those "imperfections" are only at the margins and do not present serious practical problems for corporate planners or trial judges. Perhaps also a "cure" for those "imperfections" by more elegant articulation or "doctrinal pruning" would be beneficial and we would consider cogent arguments along those lines in future cases. But in doing so we must be mindful of the possibility of unintended consequences. And we must keep in mind that the worst enemy of a "good" plan can be a "perfect" plan. So, it is in that context and with that caveat that I believe a simplification of analysis may be a proper goal and that I could be attracted to some of the authors' ideas in an appropriate case. But I do not read those ideas as urging a "sea change" in the protection

of stockholders' interests. Stated differently, we must be mindful of another old adage: "If it ain't broke, don't fix it."

Now, it (i.e., our jurisprudence) may or may not be "broke" or "badly bent." But the Delaware Legislature has not seen fit to legislate differently and corporate managers and stockholders alike seem to find the Delaware corporate climate to be hospitable to about 60% of the Fortune 500 and over 320,000 corporations. Consider recent proxy statements of firms seeking stockholder approval to reincorporate to Delaware. There are a number of examples such as Hewlett Packard and Dole Foods. The Dole Foods proxy statement this spring told the stockholders:

> The Board of Directors believes that the principal reasons for considering such a reincorporation are:
>
> 1. the development in Delaware over the last century of a well-established body of case law construing the Delaware General Corporation Law, which provides businesses with a greater measure of predictability than exists in any other jurisdiction;
>
> 2. the Delaware Court of Chancery, which brings to its handling of complex corporate issues a level of experience, a speed of decision and a degree of sophistication and understanding unmatched by any other court in the country, and the Delaware Supreme Court, the only appeals court, which is highly regarded and currently consists primarily of former Vice Chancellors and corporate practitioners . . . .

CONCLUSION

We have stated in cases—the 1996 decision in *Williams v. Geier* is a good example—that stability and predictability is our goal. While we should never turn a blind eye to correcting wrong or outmoded doctrine—and we did so in the early 1980s in *Weinberger*—neither should we restate doctrine in an untested and uncertain way.

If some of the notions in this article were presented to us in a brief in a case where the issue is relevant we would of course consider them. The question is whether there is a practical problem for corporate planners and corporate boards. Good—and best—corporate practices are going forward in boardrooms all over the country. The level of the standard of conduct of directors has improved immeasurably since 1985. Good counselors are

guiding the process successfully. And the Court of Chancery—where the "rubber hits the road"—is doing an outstanding job day-in and day-out.

So, if our jurisprudence may be inelegant and could stand some minor "tweaking," the question is whether it is broken from a policy point of view. We'll wait for a litigant with a good brief to tell us that. Stay tuned!