This is an edited and annotated transcript of the proceedings at a symposium on the *Judicial Standards of Review of Corporate Fiduciary Action*, held on May 23, 2001, at the DSBA Young Conference Center, Wilmington, Delaware. The symposium was sponsored jointly by the Corporate Law Section of the Delaware State Bar Association and Widener University School of Law.

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I. OVERVIEW OF STANDARDS OF REVIEW

Presenters

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Former Chancellor, Delaware Court of Chancery

The Honorable Jack B. Jacobs
Vice Chancellor, Delaware Court of Chancery

The Honorable Leo E. Strine, Jr.
Vice Chancellor, Delaware Court of Chancery

Commentator

The Honorable E. Norman Veasey
Chief Justice, Supreme Court of Delaware

PROFESSOR HAMERMESH: I want to welcome you to this program on behalf of the Corporation Law Section of the Delaware State Bar Association and the Widener University School of Law Institute of Delaware Corporate Law.

Very briefly, let me thank in advance my fellow planners of this event, Hank Gallagher, Lewis Lazarus, and also thank the panelists on this program, particularly the presenters.

In your materials you have papers prepared by Chancellors Allen, Jacobs and Strine, as well as Lewis Lazarus, Professor Paul Regan, Greg Varallo, and Dave McBride. Those people have devoted an enormous amount of time and effort in preparing what I thought were excellent essays that set and are entirely in keeping with the tone of this event today.

The core subject of today's program, as you all know, is the issue of standards of judicial review of corporate fiduciary conduct. These standards have proliferated, perhaps become a little bit fossilized, to the point that the substance of my introduction today would most appropriately make a reference to Forrest Gump's friend Bubba in the movie Forrest Gump, where you got your business judgment rule, you got your presumption of good faith and due care, you got your two-prong Unocal test, you got your prima facie independent outside directors' rule, you got your proportionality review, your preclusive draconian standard, your range of reasonableness standard, you got your compelling justification standard, you got your entire fairness
standard, your fair price, fair dealing standards, your shifting fairness burden for stockholder ratification, your waste test, etcetera, etcetera.

And what I have thought, and a lot of people on this panel and I know in the audience have thought, is that perhaps it is a good time to talk about rationalizing or rethinking the basis for these various standards of review. Therefore, this is not an ordinary CLE. This is not going to be a situation where you are told about the most recent cases and hearing from the judges what they thought when they wrote those cases. The participants today were invited not just a report on but also a critique of and perhaps a de-construction of the state of case law in this area.

Given the panelists we have today and given the members of the audience, I can see that it will be a great opportunity for self-study and I hope advancement in the quality of the law, and not just a top-down presentation. My hope is that in each panel there will be time for active questioning and participation from the audience, and so please feel free to keep your mouth flexible here.

And without any further delay on my part, let me turn it over to our first panel, which consists of former Chancellor, Professor William T. Allen, now at the New York University School of Law and Business, and Chief Justice E. Norman Veasey, who needs no introduction—in fact, none of these people really do—Vice Chancellor Jack B. Jacobs and Vice Chancellor Leo E. Strine, Jr.

And to show you how thoroughly coordinated this is, I am not even sure which of these gentlemen is going to critique first so I will sit down and be surprised.

CHANCELLOR ALLEN: I am delighted to be here, back in Delaware, and to participate with you in a discussion of the structure of the Delaware corporation law.

Vice Chancellors Jacobs and Strine and I have written a paper that has been furnished to you. It is a working paper. What we would like to do today is to raise the issues that we have discussed in this paper. We will describe them briefly, and hope to hear critique or suggestions from you. You are as knowledgeable as we, spend as much of your life dealing with these issues as we, and so we very much want your input before we finalize our thoughts on this subject.

We thought I might open for us, since I am now a professor and so am going to be pedantic about how we suppose the Delaware corporation got to where it is today.

Today we are in a very different place in corporation law than we were when I first came to the bar in 1972. It seems to me that corporation law has changed in a fairly fundamental way.

If you take the period say from the great Chief Justice Wolcott's tenure starting around 1920, a little earlier, up through, say, 1985, I think the
Delaware corporation law was evolving but evolving at a slower pace than more recently. During this early period, the legislature was a more important source of evolutionary change than in the next period, and, number two, we were evolving away from a corporate law statute that was much more confining than the statute we have today.

So if you look at the early corporation law cases, early in this century, a lot of them deal with subjects that we don't deal with any longer. Statutory subjects, ultra vires, par value of stock and pre-emptive rights, for example. There are a lot of statutory issues that courts used to have to grapple with, but now because the statute has become so open and flexible, so enabling in character, we really don't see these as problems in court any longer.

We witnessed, however, as a counterweight an evolving use of the fiduciary duty concept. Nowadays I think it is the case that practically all corporate litigation in Delaware, a great part of it, anyway, is fiduciary-duty based. This was not the case earlier. But as the statute became more enabling, as directors were given greater and greater discretion, and shareholders continue to be disaggregated through capital markets, this default obligation of fiduciary duties necessarily became more important. It was always important, of course, but it has become the central aspect of the court's role.

The fiduciary obligation in the early part of the century really looks like the duty of loyalty.

Those cases that are not construing the statute or a bylaw have to do with conflict transactions or with a category of cases that you can't exactly say how the conflict comes up, but there is some funny business going on.

And the funny business cases are dealt with under the language of fraud or constructive fraud.

We had a duty of care in theory in those days of course. It is embedded back to the 1700s in corporation law. But while there were one or two rare exceptions, plaintiffs did not bring actions claiming that disinterested directors had breached a duty of care, because they would not win. They would be dismissed.

These cases just didn't exist. The fiduciary duty of corporate directors was essentially a loyalty-based body of law.

Now, in this period, there were a few cases that fell into what later developed into very broad category of cases, what we now call cases implicating an intermediate standard of review.

There were some cases in the earlier period that did not involve a straight conflict of financial interest, but that there was some activity that kept the existing team in place. I wrote an opinion in 1987 (Speiser v. Baker) that caused me to review the history of cases dealing with voting shares of parent stock owned by a subsidiary. I went back and I found cases from the early 1800s until the 1930s. There were always cases in which
courts were ready to protect the integrity of the voting process under some principle, but it was never really articulated very well what the principle was. The cases were early intermediate standard cases in an incipient form.

In Delaware, finally with Schnell v. Chris-Craft we got a principle to deal with them. Now that standard is in truth a radiant generality. You can't do something that's inequitable just because it is legal. You couldn't ask for a broader principle than this one. But it wasn't very developed.

But in Cheff v. Mathis and other cases we had some beginnings of a development of fiduciary review where you didn't have a clear financial conflicting interest.

All of this changes in 1985, in what everybody refers to as a revolutionary year, the cases that we know about, Van Gorkom, Revlon, Unocal, and a very important case at the time, but less fundamental perhaps, was Moran v. Household.

Van Gorkom is a case some of us spent a day dissecting last week.¹ You know it, so I am not going to vent my spleen any longer on it. But what it did for standards of review is it brought the duty of care forward as something more like an equal partner to the duty of loyalty.

With this intermediate category we had begun the takeover era. KKR became very active in the late seventies. Perelman did his Technicolor deal in 1982. The takeover movement was very obvious by the early eighties and certainly by the mid-eighties.

Takeovers presented unique problems, and the court understood that the existing toolshed maybe didn't give all the right tools to deal with this kind of problem.

The process was a form of creativity and was painful to some extent. The first approach the courts tried was due care.

Well, this was the wrong concept in my view. The idea was a good idea, or the intuition or the instinct was a good idea, but due care was the wrong tool. And so the court in Van Gorkom wrote an opinion that, in my opinion, just doesn't withstand analysis. But it did invigorate this idea of due care and made it much more real and made life difficult for teachers of corporation law, because the case is too important not to teach, but, on the other hand, it doesn't fit.

When you are teaching corporation law and you want to teach the duty of care, you should teach American Express v. Kamen, which is the standard duty of care case: the directors made a stupid decision; forget about it.

But everybody has to put Van Gorkom in there and it confuses the students. Van Gorkom should be back with the takeover cases. Because that's what it is. Anyway, it revitalized the concept of due care.

And then came Revlon and Unocal, and they looked very revolutionary. They looked more revolutionary than, in fact, they turned out to be, which from my conservative point of view is a good thing.

And no one understood exactly what the Revlon standard meant or required, and so we had years from Revlon through QVC, in which the courts were clarifying that standard, which raised problems of its own. There was great confusion between Revlon, Unocal, and QVC.

We think that the Delaware courts, particularly the Supreme Court which at the end of the day makes the policy—the Chancery Court merely suggests ways that it might do that—we think that the Delaware Supreme Court was faced with a difficult, difficult challenge by this takeover movement, and if you look at the end of the day how it came out, I think it came out pretty well.

The court's difficulty was that this was a hotly contested issue of public policy. There was an inability in Washington to have a coherent takeover policy. Very big institutions, business institutions were being subjected to large stresses. Communities all over the country were being affected by this takeover phenomenon, and the Delaware court had only a narrow legitimacy ground to deal with it.

That is, it is potentially problematic if you are a citizen of California or a legislator from Oregon that an important company is incorporated in Delaware and the Delaware courts are going to tell you what the duties of the company and its directors are. It is fine if the duties at issue are whether the preferred stock gets paid or you have to have an annual meeting or not have an annual meeting. These are kind of technical issues.

But when the issue is, will this company change its ownership structure, will it close plants in my community, people begin to wonder whether it is such a good idea to have Delaware calling these shots.

So the Delaware courts had a practical political problem. I think this accounts in some part for the fact that the policy dimension of these decisions is not so clearly articulated.

It was I think Bayless Manning who analogized the court's handling of the cases to a sailor walking on a boat. One case would come out this way, another case would come out that way. Part of the explanation was that there were strong political forces, such that if the court went too far in any direction one of those political forces was going to come and hotly criticize it.

And the second aspect was that in my opinion the Delaware courts did not have a thought-through coherent doctrine, so they were feeling their way.
This is not a harsh criticism. These forces were novel and the strength of the common law lies in its step-by-step evolution.

Our idea is that there has been a lot of feeling of the way, and it may be a time to think about the overall structure again, particularly of this intermediate group of cases.

And so that's what we mean to do, in the hope that the bar will discuss these subjects and that others will think about the possibilities that we have now to try and simplify, because the political climate has changed. I think the courts have social capital to make some clarifying decisions, and so that's what we are about.

Now, I am going to turn to our panelists. What we want to do is talk about due care, talk about the effect of intra-corporate approval on transactions, special committees, ratification, that kind of thing, and talk about Blasius.

Can we turn to Vice Chancellor Jack Jacobs, who will begin a conversation about the due care, Van Gorkom, Cede and some of those kinds of issues.

VICE CHANCELLOR JACOBS: Thanks, Bill. Let me just add a few comments to what Bill said before I get into that subject, because this is an unusual format. There are currents here that are implicit, but I think it would be good for the trial judges here to make them explicit.

There is a draft of an article that former Chancellor Allen, Vice Chancellor Strine, and I wrote. It is in your materials. And it is critical of some of the existing standards of review, and makes proposals for what may be a better system of rules. We are going to be talking about that today.

I think it is important to get out on the table that in doing this we were not seeking to appear like a bunch of up-starts, criticizing the authority of the Supreme Court as an institution. We all know that the final word on standards of review comes from the Supreme Court, and when we wear our hats as judges, we enforce those rules whether we as individuals agree with them or not.

But it is also the case that even for judges, the ethical rules carve out an area where they are allowed to participate in activities that involve improvement of the law. Many of the ethical decisions in that area involve judges speaking out in favor of or against legislation. But we also submit that common law is folded into that protected area as well, which is why we are here.

I start with the plain fact that there is no such thing as a perfect rule. At least I think no one of us is aware of any rule that works perfectly well in all circumstances and at all times, particularly in the corporate area. That is why the common law continually evolves.

One important purpose of our being here today, and what I think we share in common, is an interest in seeing that the Delaware corporation law
evolves in the right direction. And when I say "we" I mean that when we sit here we are really wearing our hats as lawyers and talking to you or with you lawyer to lawyer, in a common effort to see if we can craft a better way. That is the spirit in which Bill Allen, Leo Strine and I wrote our article, and that is the spirit in which we appear on this panel today.

I now turn to what I was asked to talk about—the duty of care, as that duty has been impacted by *Cede v. Technicolor* and (to use my word) "transmogrified" into an entire fairness analysis.

I know that all of you have read that case and are familiar with the 1993 decision that we call *Cede II*. Until that case was decided, claims of breach of duty of care were analyzed and decided under quite different standards from claims of breach of duty of loyalty. Indeed, the two sets of analyses were compartmentalized and kept separate from one another.

Due care, for example, assumes that the directors who make a decision are disinterested and are acting in good faith, but, nonetheless, stand accused of not meeting the standards of care, whatever they may be. In cases where due care is the claim, before *Cede* the plaintiff had the burden of establishing a *prima facie* case of gross negligence. The plaintiff had the burden of proof, as well as the burden of showing that the gross negligence caused harm either to the corporation or to the shareholders, depending on what kind of lawsuit is involved.

If the plaintiff was able to show that, then there would be director liability, at least before Del. Code Ann. tit. 8, § 102(b)(7) was enacted. If not, that is, even if the director's conduct was grossly negligent, if no harm resulted from it the claim would be rejected.

Turning to the separate compartment of loyalty claims, there we are referring primarily to cases where the majority of the board is conflicted and approves a transaction that is the subject of the board conflict. In that case, our law traditionally subjected that conflicted board (or the majority stockholder if that stockholder was a prime actor) to a rigorous entire fairness standard under which the burden falls on the director (or majority stockholder) to establish the entire fairness of the transaction. In close cases, that meant that the ruling would go against the director.

Now, importantly at least for this discussion, the only circumstance that triggered fairness review was where the transaction terms were fixed by the directors who had the conflicting interest, and the claim was that as a result of that conflict, the fiduciaries received a benefit that was not shared by the minority stockholders. Never before *Cede II* was it thought that a showing of gross negligence to conduct by unconflicted directors who were acting in good faith would trigger entire fairness review.

*Cede II* changed all of that. As we know, it held that if directors are shown to have breached their duty of care in the sense that their conduct was grossly negligent, even if the plaintiff is unable to show that that negligent
conduct caused harm to the corporation it would, nonetheless, subject those directors to entire fairness review. As a result, the directors would have the burden of showing that no harm resulted from their conduct and that the transaction that they approved was entirely fair both as to process and price.

So what we now have are directors who are charged with the duty of care violation being treated, from a burden of proof and a quantum of evidence standpoint, as if they stood accused of a breach of a duty of loyalty.

Now, in our paper we point out several problems with that approach. One of the problems in even coming to grips with this is that the court in Cede—and, by the way, Chief Justice was not on that panel.

One of the problems is that there is no rationale that the court stated for drawing this linkage between the duty of care and the duty of loyalty. In my private moments I have speculated as to why, what the rationale might be, and I have come up—speculatively—with two possibilities.

One is that the court may have reached that result out of a concern that as a result of Section 102(b)(7) the duty of care had been weakened, and that it needed to be strengthened in cases where there might not be a monetary recovery. The way to accomplish that would be to impose a heavy procedural burden on directors who violate the duty of care, in order to deter that kind of conduct.

The difficulty with that rationale (if it was a rationale) is that it is a form of overkill that fails to take into account that there are other ways to deter grossly negligent conduct. One way might be to require not entire fairness review but perhaps "reasonableness" review. Moreover, the Cede approach undercuts the policy that underlies the entire gross negligence standard—to give directors enough breathing room so that they will feel free to engage in risk taking activities, which is what directors, in their capacity as managers of a business enterprise, are supposed to do.

The second possibility that occurred to me,—and again, this is just my own musing—is that there may have been a notion that because the business judgment rule is a presumption that can be pierced by a showing of gross negligence, then once that showing is made the presumption vanishes and some other standard has to apply. By default it was entire fairness.

But, the difficulty with that approach is that there are other default standards besides entire fairness. By 1993 there existed a panoply of intermediate standards, but that possibility wasn't addressed in the opinion.

So, the problem is not so much one of shooting at a moving target, as it is shooting at a target that is invisible. But nonetheless, and I will be very brief about this so we can hear from the other panelists, there are reasons, particularly given the experience that we have had since 1993 in Cede II, why the proposition that a showing of gross negligence should trigger entire fairness review is flawed and that we should go back to the "old" conceptual framework.
There are two rationales for entire fairness review. One of them is that where the transaction is approved by conflicted directors, it is very difficult to determine what price the market would place on the transaction. That is, normally when unconflicted directors negotiate on behalf of all the stockholders, you attain a market-priced transaction value. That result cannot be presumed when the directors are conflicted. But this concern is not implicated where the directors are not disloyal, but are at most not careful.

A second rationale for entire fairness review is that because of its strictness and because entire fairness is a difficult standard to meet, it operates as a deterrent to faithless conduct. The very statement of that rationale shows, however, that it has little to do with the duty of care. By definition, directors who stand accused of violating the duty of care are not faithless. They may be careless, but they are not faithless.

We think that the linkage between gross negligence and entire fairness review should be broken because (in addition to the foregoing ) the entire fairness analysis is not really very helpful where the conduct that is being challenged does not involve a transaction. That is, entire fairness review works analytically where there is a merger, a sale of assets or other kind of business transaction. But, where the business decision is not transactional, such as a decision to enter into a new market, or to exit from an old market the analysis does not fit comfortably.

Another reason for breaking that linkage is that to treat directors accused of breaching the duty of care as if they stood accused of breaching the duty of loyalty turns the procedural rules upside-down. That is, it is unfair to put those directors in a worse position procedurally than someone who is accused of negligently driving a car and causing an accident.

And finally (and we touch on this in our paper), the thought process that motivated Cede has also, we think, inspired the view expressed in the 1999 Emerald Partners decision, that for the directors to advantage themselves of a Section 102(b)(7) exculpation clause in the charter when they are accused of breaching the duty of care, they must carry the burden of (1) establishing that the exculpatory clause applies and (2) negating all of the statutory exceptions. We think that for the same reason the Cede II linkage of entire fairness and the duty of care is flawed, so too is the Emerald Partners doctrine.

So where we come down, and I will stop here, is that the post-Cede II experience has shown that our standard of review system would be improved by returning, at least in this area, to the way the law was before Cede II was decided in 1993.

CHANCELLOR ALLEN: Well, perhaps we should take a minute to see if there are any comments about this.
You have the gist of our notion, and, that is, we don't see advantages to the structure in which due care obligations are now adjudicated. Now the business judgment rule is used to convert the protective business judgment rule and turns into a way in which directors get less protection than other alleged tortfeasors.

One of the things that we didn't discuss in our paper is that invoking the loyalty approach in care cases confuses the remedy or range of remedies available.

In a standard tort case we have a lot of law about how damages are measured by the extent of the injury to the plaintiff. In loyalty cases we have a different body of principles that talk about remedy. We have trust law ideas, and it is possible that you can make an argument if you have a loyalty breach that you get the highest intermediate value, for example, of an asset wrongfully converted.

So that the entire fairness level of damages or technique for determining what the judgment is may be rather different and more onerous, because it is usually applied to breaches of loyalty. We put great burdens on these defendants.

If you convert a care violation into an entire fairness or loyalty problem, you may be importing more onerous liability standards, and I don't think anybody thought about that at the time.

Questions or comments?

[Audience question concerning Cede II.]

VICE CHANCELLOR STRINE: There are choices that are made in the law, and this is a point we make in the paper, there was a conscious choice in the corporate context to set the level of culpability at gross negligence, and I analogize this to having, you know, been adviser to a governmental officer, we make the same choice with respect to public officials who exercise discretionary decisions. We don't want a police officer being held liable for negligence because they are probably not going to be very effective at protecting the public safety.

I think classically the thought has been that with respect to profit-making enterprises like corporations, we want the directors to be able to take risks, and the thought is if you act like they are trustees, like a trust, because traditionally, as you know, trust law, and it is moving in the other direction, has been so risk adverse that they put money in bank accounts when it should be prudently invested in other things.

In the corporate area we want the directors to engage in risk, and so the thought is if you have elected directors, you have had a chance to look at their qualifications, you have elected them, they have exercised good faith, that if you want to hold them liable for the breach of the duty of care it ought to be something way out of the realm.
And we see that as a policy-based judgment that has been made and that is inherent in the gross negligence standard, and we see Cede as undercutting it.

VICE CHANCELLOR JACOBS: Just to add one thought to what Vice Chancellor Strine said, to the extent that Aronson and Van Gorkom articulated gross negligence as the standard of review or the standard of liability for directors, we think that is absolutely right. The problem, as we point out in the paper, is that in Cede and in other cases the courts have not been applying that standard. They purport to apply it, but in fact appear to be applying a simple negligence standard. That is the problem.

CHANCELLOR ALLEN: Yes, sir.

JOHN HARNES: I have two questions for Vice Chancellor Jacobs. You said that in cases where only the issue of care is implicated, then that doesn't implicate the workings of the market as in a duty of loyalty case. My first question is, why not? If you have an incompetent director who negotiates faithfully but not in a competent manner, why is the ultimate price that's arrived at not reflected in the market?

VICE CHANCELLOR JACOBS: Well, that is a good question. There may be some market impact, but when you have directors who are trying to avoid a fair market deal price intentionally by basically engineering the transaction to serve their own interests, then you have the maximum distortion from what would otherwise be a market-priced transaction.

If you have negligent conduct, grossly negligent conduct or even negligent conduct, that may or may not be the result. But the proposition is that negligent conduct will not have that impact on the market in all cases.

CHANCELLOR ALLEN: Did you have a second question?

MR. HARNES: I had a second question. As I understand the basis of fiduciary duty is that investors are entrusting their money to managers to manage their investment, and given the presumption of the business judgment rule and the corporate structure right now, unlike the normal professional relationship, the shareholders have virtually no say or very little say in how those managers manage their assets. Why is it unfair to hold a director to a higher standard than a simple manager?

CHANCELLOR ALLEN: If I may suggest, one answer which I think would be our answer is that shareholders have open to them a very wonderful alternative, diversification in the market. They are exposed only to the extent they want to be exposed to risk, and they may sell instantaneously if there is a market price.

And so it is what Vice Chancellor Strine said a minute ago. It is a social judgment that, on balance, we think society will produce more wealth, will be better off if corporate directors are not put under risk of second-guessing on the quality of their decisions and the shareholders are protected by diversification.
If you want to invest in chemicals and you don't want the risk of any particular board making a stupid decision, invest *pro rata* in all the major chemical companies.

And so diversification provides a systematic answer to this question.

VICE CHANCELLOR JACOBS: One other policy consideration underlies having the more lenient gross negligence standard. The policy is that if simple negligence is the standard of liability (or what we refer to as the standard of review), it becomes easy in hindsight for courts to conclude that a decision that was reasonable at the time, but turned out wrong, was grossly negligent.

Whenever directors take risks, the law of probability dictates that there is a risk that the result will go in the wrong direction. But that does not mean that the directors made a grossly negligent decision.

So if we have a standard of review that penalizes the director by imposing personal liability in those types of situations, we will make it difficult for good people to accept directorships, which would defeat the underlying economic purpose of corporate enterprise.

CHANCELLOR ALLEN: We will take one more question. I think Betsy had one in the back.

ELIZABETH M. McGEEVER: I do have a concern that this approach may relegate the duty of care to a second-class status. It seems to me that the duty of care rule that has sprung from *Van Gorkom* has been good, in that people do take more time to make decisions. People do get outside advice before making decisions. So that seems to me to be a good thing that should be encouraged and not discouraged.

VICE CHANCELLOR JACOBS: I agree with all of that, but the question is, do you accomplish that goal by subjecting directors to entire fairness review where they are accused of gross negligence and the plaintiff is unable to show damages?

CHANCELLOR ALLEN: Well, as chairman let me have a prerogative of having the last word.

I think the public policy of the state, and really of the nation, is 102(b)(7). I think that there was, in fact, no risk of disinterested directors having liability for damages for breaches of care prior to 1985, or *de minimis* risk.

I think as soon as this idea was put forward, legislatures enacted statutes like 102(b)(7) and that these statutes went to shareholders for ratification in amendments of charters and no institutional investor was opposed to them.

So I don't agree that it is a net big gain. I don't think that we talk about care more.

But I do think that what we are talking about is doctrinal pruning, of just making it a little more sensible and rational. We are not saying do away
with the notion of due care liability any more than it has been done away with by 102(b)(7).

We are just saying make the theory a little clearer and more consistent. Anyway, that's what our idea is.

Now, I am going to turn to Vice Chancellor Leo Strine, who is going to talk about another part of our paper, which is intercorporate approvals.

VICE CHANCELLOR STRINE: I am going to talk about it a little bit from a broader perspective. Our paper is called function over form and perhaps it is not surprising that three judges would look at standards of review functionally.

But one of the things we are looking at is how do these things actually get used as a way to make judicial decisions, how do we use different standards to evaluate the way boards of directors have acted and to determine what the appropriate legal outcome is, and for reasons I want to talk briefly about, we don't view the business judgment rule as a functional standard of review.

It is said, for example, that there is a presumption that directors act with due care. That's a presumption in the business judgment rule. Well, how do you rebut that presumption? You prove breach.

Well, that's not any different than anything else in the law. There is a presumption that directors act loyally. How do you prove that? You prove they didn't.

So the way you get to the promised land of the business judgment rule is by going through different analytical tests, separate tests, which in our view are actually the standards of review. And one of the things I think our paper adds up to is an attempt to do a little bit of pruning that gets courts out of things that can be decided more appropriately by other corporate constituencies.

Many of the corporate standards of review that have arisen, arose because of concerns that the appropriate corporate methods of decision making can't be trusted fully.

Interested director transactions we look at with suspicion.

And one of the areas I want to talk about is how we deal with majority stockholder transactions. And classically, as you know, if there is an interested director transaction that is approved by a majority of disinterested directors or approved by a majority of the disinterested stockholders, then that will be sufficient to obviate any entire fairness review.

Because of concerns about the adequacy of those protective measures, there has been an exception carved out in the case of, particularly in the case of going-private transactions that are proposed by majority stockholders. And the *Kahn v. Lynch* is I think the most recent case that really touches on this, which says if you own eighty percent of the stock of the company and you want to buy out the minority's twenty percent, even if you negotiate the
price of that transaction with a well-advised committee of independent directors, or even if you explicitly condition your purchase of the twenty percent on the approval of a majority of that twenty percent of the electorate, you say you won't go forward unless that twenty percent of the electorate, a majority of them, vote for the deal, even if you do either of those two things, you don't get out of entire fairness review. You simply get into something that we would call "entire fairness lite," which is that the burden shifts to the plaintiff to prove unfairness.

What we ask is with the experience of time whether those exceptions are really useful. Let me start with whether a deal expressly conditioned on approval of the majority of the minority vote should be entitled to business judgment rule deference. Our premise is that it should.

The contrary thought (expressed in Kahn) was that even if you did that and you said to the twenty percent, you have the right to turn this down, to agree with it or not, that if you turned it down that the eighty percent stockholder is going to harbor retributive thoughts, and after you vote no is going to punish you, is going to withhold dividends, he is going to do other things.

And I think there is also lurking a suspicion that, therefore, that the vote is not really a free vote, and maybe a suspicion about whether people believe that the voting process is all that it is cracked up to be.

Professor Clark I think wrote suspiciously about this in the eighties. Other people did.

I guess what we think is that really we think we ought to be able to handle the angry gorilla problem later on, that there are plenty of cases when the angry gorilla, if the angry gorilla has paid, the company has paid dividends for the previous 20 years, just decides not to pay dividends because he has, you know, lost a vote, that we ought to be able to handle that another way.

We also think that there is increased stockholder activism and an invigorated voting process, and we would suggest it is not worth the candle, that once the court has looked at the disclosures, because we will police the disclosures, we will police whether it is coercive, when it is given to the minority to choose for themselves whether they accept the price, we don't think it is worth the process to go forward with something called a fairness review.

Similarly, if you look at the cases that analyze what you have to do to determine whether a special committee is given even burden shifting effect, Kahn v. Tremont, for example, in order for there to be any weight given to the special committee process there has to be a fairly extensive examination of that process, a conclusion that the special committee, in fact, acted independently, was well advised and acted as a proxy for arm's length bargaining.
We think that the special committee process perhaps has evolved to
the state, there is now that level of judicial confidence, that it should be
given the burden shifting effect that it is now given, that that will be enough.
It ought to invoke the business judgment rule.

And we understand that there are risks to that and we would like to
hear from you about it, but, again, it is our view that that would be an
appropriate way to channel decision making into intra-corporate fairness
mechanisms and away from the ultimate judicial review of the fairness of the
transaction, and that's part of what we sort of throw out as a couple of areas
we might be able to trim back a little bit.

CHANCELLOR ALLEN: I think part of what you, when you hear
the three of us suggest something like this, you are getting the insight from
people who have had to deal with this fair price, fair process questions, and
at the end have some doubt about the integrity of that process.

I mean, you come up with a good faith decision, but is this socially the
best default? I have had cases in which we are trying to figure out values,
and at the end of the day it is so complicated, that one may sensibly place
little faith in the number that you come up with. It is a good faith attempt by
a knowledgeable person, about law anyway.

But how good is this process at determining "fair" prices. Maybe we
see this judicial fairness hearing as more frail than people that appear before
us do.

Anyway, the idea here is that maybe the courts can do the most they
can do by really reviewing the procedure, and in looking at the independence
of the committee, the way the committee is represented, the way the
negotiations go, and make a judgment about integrity of the procedure, that
the courts feel better about doing that than coming up with numbers.

And if the procedure is sound, subject to scrutiny, I don't know what
phrase we want to use to signal that they are supposed to look at it with some
scrutiny, but, then, if that's the case, give it the business judgment treatment.
That's the idea.

[Audience question concerning claims of inadequate disclosure.]
VICE CHANCELLOR STRINE: I think an important part of the
integrity of our proposal is that we understand that we will hear, that the
courts are open to hear disclosure claims and to examine whether a deal has
been structured in a way that takes away choice.

That's a real linchpin for us. And so whether it is a tender offer or not,
as long as the disclosures are adequate and it is not structured in any coercive
way I think that we would not see that as an important distinction.

But I want to emphasize that we would still—the disclosures have to
be adequate, it can't be coercive and that's the integrity.
We are emphasizing trying to put decisions in the right hands and maybe intervene where we need to, but allow stockholder choice and board action where we can.

CHANCELLOR ALLEN: We are going to hear some reactive comments from the Chief Justice. I want to give him five minutes at least. But he can make us stay longer. You know that.

But I will take one more question.

[Audience question concerning the efficacy of special committees compared to stockholder vote.]

VICE CHANCELLOR STRINE: I think we more easily accepted the notion that the stockholders themselves, having a free choice, that we have a hard time understanding how as judges we come back when there has been a vote that has no tainted disclosures, a majority of the minority vote, how we are ever supposed to conclude it is unfair and, in fact, if you look, find me the case where it happened.

CHANCELLOR ALLEN: On the other hand, as a practical matter I think the business people would say that in a cash-out situation, for example, that the directors understand that they have got a different status, and that this is the end of the game, and their job now is to negotiate, and if they have got independent lawyers, if they bring some specialist firm in to talk to them, you are apt to get more real minority protection, a higher price from the director level of protection than from the vote level of protection.

From a judge's point of view, once you have a fully informed vote, that's a very powerful fact.

But I do think, from my view, that independent committees, if they are done right, probably give as much or more real protection to minorities.

Let me turn so our senior member gets an opportunity to make any comments that he might want to.

CHIEF JUSTICE VEASEY: Thank you. I recently re-read a law review article by Bayless Manning, who was the dean of Stanford Law School and a practitioner in New York. He was actually talking about life in the board room after Van Gorkom, but one of the things he said (facetiously) in the paper was that one should pity the Delaware Supreme Court having to work under the klieg lights all the time and having to be criticized by law reviews, and now Chancery judges.

Bill Allen makes the point of the Delaware Supreme Court was groping its way along in the takeover era, trying to come up with some jurisprudence that would make things work and to develop responsible jurisprudence. I think that it is very interesting that internal affairs of most corporations are really decided by ten judges sitting in Delaware, five Chancery judges and five Supreme Court justices, and that the personalities keep changing. I mean, they are different people all the time.
The paper that Bill and Leo and Jack have written I think is an excellent paper. I really encourage you to read it and I encourage those of you who are briefing cases before the Delaware Supreme Court to keep it in mind. I think it is scholarly. Although they present sound rationale for doctrinal pruning that they talk about, that's not to say that I agree with everything that is in there.

I think that the cases as we now see them are not necessarily always neat or elegant in the way they deal with the jurisprudential principles, as well as the facts of life. I think we know a little bit about the facts of life, and we have seen the doctrines cobbled together by different courts over a period of time.

I would be attracted to some of these ideas myself in a proper case. Some of the issues that are talked about or hinted at in the paper and that you have heard this morning may be in the pipeline for our consideration.

But one has to keep in mind that judges are like clams in the water. We have to wait for something to come our way. We don't reach out to improve the law, ex cathedra. We have to have a proper case presented to us, and we all know that cases are decided often on highly textured, fact-intensive situations, circumstances, and procedural posture.

The Delaware Supreme Court was criticized recently for the McMullin/Arco case. That may or may not be just criticism, but one has to keep in mind, that case was decided on the appeal of the granting of a 12(b)(6) motion, where one takes the facts of the complaint as pleaded and you deal with what the plaintiff has said.

As for the cases that are mentioned in the paper, I think one needs to focus not only on the whole, but the parts. For example, Van Gorkom, Cede, Emerald Partners, and Kahn v. Lynch.

I had nothing to do with any of these cases. I think I was disqualified in some of them.

As for Unocal and Unitrin, I was on the panel in Unitrin. Blasius is a Chancery decision of Chancellor Allen's, a thoughtful decision that has been cited with approval by the Supreme Court, perhaps not with the kind of analysis that is brought to bear because when it is cited it seems to be cited as a kind of footnote idea more than a central holding that is a mirror of Blasius itself.

The conclusion of the paper is the desirability of a reworking of the standard of review map, and I think such a review is probably a good goal, but, again, we have to wait for the cases to come to us.

The fact is that the Court of Chancery is so good, and the judges of the Court of Chancery are such outstanding judges, that very few cases actually come to the Supreme Court in the corporate area. I think that the statistics that I have given a few years ago—it may or may not be true today because I haven't taken another look at it—are that the Supreme Court's
docket of case numbers consists of about five or ten percent of pure internal corporate affairs cases, and the Court of Chancery’s docket is about seventy-five percent of those kinds of cases.

Of those corporate cases decided by the Court of Chancery, I think ninety percent are not appealed, for one reason or another: the decision is so good, people move on, economics or whatever.

So we may or may not get any cases that will help us to rework the standard of review map. There are some things that are in the pipeline now that may or may not bring us to that day.

Now, in saying I didn't have anything to do with these cases, I don't want to be like Pontius Pilate. These are precedent of Delaware. These are cases that we deal with every day in looking at the situation. These are cases that sound judges have decided, from time to time, in considering what was the right way to articulate the standard of review.

So I would look at those cases with a great deal of deference, and I would also look at this paper and briefs that brought to us good arguments with an open mind about what is the best way to approach what my friends here call "doctrinal pruning."

For example, does the overlay of Blasius and Unocal make sense? Does all of the analysis in Unitrin make sense, and does it work?

I think one of the things we must consider here is whether it is broken down, does it work, and is Delaware jurisprudence as a whole an effective tool for corporate practitioners to plan, and for Chancery judges to sort out when they get the cases, when the rubber hits the road.

So rather than talk about the specifics of some of the things that we are talking about here today, because I have run out of time and it is probably not appropriate to do that, let me just say what I think the obligation of the law is. And this is that we deal in an environment of judge-made law in Delaware. It is a form of common law, done in the context of specific cases as the law develops over the years.

The law needs to be coherent from an economic analysis, as well as to provide scholarly, principled coherence. It needs to be workable, for people to be able to plan upon and deal with in the business area and for trial judges.

In the corporate area the law needs to encourage risk-taking by directors, and that’s a very important part of the economic coherence involved.

The law needs to encourage best practices. I think Smith v. Van Gorkom did have a therapeutic effect of getting people to engage in best practices, and that is going on today.

The law needs to discourage any kind of self-dealing or duty of loyalty problems, and the courts need to be especially skeptical and attuned to what Chancellor Allen called "funny business."
So that's about all I have to say.

CHANCELLOR ALLEN: Thank you, Chief Justice. Larry, I think we have exhausted our time.

PROFESSOR HAMERMESH: I would be glad to take another five minutes or so if people have questions. We started a little late.

CHANCELLOR ALLEN: If there are any questions, comments, exhortations?

PROFESSOR HAMERMESH: In the words of the Van Gorkom dissent, why don't we have a fast shuffle here. We will end this panel.

Before you leave let me just thank you all, Vice Chancellor Jacobs in particular for your thoughtful and candid remarks about the nature of your function here.

This is an unusual presentation and a provocative one. My hope is that the panels that follow will be able to take the spirit that you have injected into this and elaborate on some of the more specific applications of these standards of review issues in specific contexts.

But, gentlemen, thank you very much for your participation.

II. WHAT'S LEFT OF UNOCAL?

Presenter

Paul L. Regan, Professor
Widener University School of Law

Commentators

Craig B. Smith, Esquire
Smith, Katzenstein & Furlow LLP

Mark A. Morton, Esquire
Potter Anderson & Corroon LLP

MR. LAZARUS:—what is left of Unocal. The presenter will be Professor Paul Regan, who is a professor at Widener and formerly practiced in this area at Skadden Arps.

Also panelists to comment on his paper are Mark Morton, who is a partner at Potter, Anderson & Corroon, and Craig Smith, who is a partner at Smith Katzenstein, both of whom are experienced practitioners in this area.
Because we effectively had a 15-minute break in between sessions, after this panel concludes we will take a short five-minute break and then go on to the next panel. Paul.

PROFESSOR REGAN: Thank you, Lewis.

Good morning, everyone. I want to thank my fellow commentators here on the panel, both Mark and Craig. We had a chance to talk about this a little bit beforehand, but I am looking forward to hearing their reaction to the finished version of the paper that I am presenting here this morning.

It is an idea that I have been toying with in my own mind for a couple years, and that I have been wanting to write about, so it was great that this seminar today gave me an occasion to work hard at how I would articulate it, and writing the paper forces me to get there.

What I would like to do is talk about Unocal somewhat historically, from where it arrived on the scene in 1985 and what followed. I will point to some key breaks along the way in terms of what I understood—at least in 1985—Unocal review to mean, to what Unocal doctrine has become at various iterations of it along the way, and finally where we are today.

I offer a critical analysis in the sense that my theme, "what is left of Unocal," suggests the answer is not as much as was once promised. This promise came in the great trilogy of Unocal, Moran, and Revlon, with regard to judicial review of defensive measures. I recognize Revlon was a change of control case, but it also had a nice little essay about defensive measures. In these landmark decisions, the Delaware Supreme Court introduced the idea of intermediate judicial review of board decisions level of scrutiny, also known as enhanced scrutiny. This intermediate level of review, now familiar to all of us, would offer a rather provocative thing: without any showing by the shareholder plaintiff that you had a financially conflicted board in the traditional sense, or post-Cede, a grossly negligent board, there would nevertheless be a judicial suspicion about directors' decision making simply on a showing that the board adopted anti-takeover measures. My thesis is that Unocal and Moran in particular really promised two fundamental protections against the abuse of director power in this scenario and that we are now only left with one of them.

And what are these two? The one is that you can always turn the board out through the proxy machinery. You see that language in those early decisions, that says to the defeated shareholder plaintiff, look, they have successfully defeated the tender offer. And you may be upset. You may have wanted that premium bid and now it has gone away. But if you don't like that, democracy is at your disposal, and just go get them at the next annual meeting. And, moreover, transaction planners could couple a proxy contest with a tender offer and thereby seek to evade the defensive measures including the pill. This proxy machinery remains a vitally important check in the balance of power between directors and stockholders in the takeover
context, and I agree with the Delaware courts' vigilant protection of that check on director powers through the years.

The second check against the possible abuse of director power that came out of Moran—and this relates to the use of the phenomenal innovation of the poison pill—went on to say that while you can always turn the board out, there is another check on director power here. "In addition," was the language of the Supreme Court in the Moran case. "In addition," there is always going to be Unocal review of the board's use of the pill in the case of an actual bid.

The idea is that separate from the proxy machinery, when a board uses the pill in the face of an actual takeover bid, we are going to separately check that director conduct and hold these fiduciaries accountable for those choices they make.

This fiduciary accountability component of Unocal review I submit has vanished. Through decisions like Time Warner and Unitrin, what we have now is what I call a proxy-centric jurisprudence for anti-takeover devices, being merely the first promise of Unocal and Moran—that you can always turn the board out through the proxy machinery, and we will vigilant protect to make sure that remains true.

The other early promise of substantive fiduciary accountability really went undeveloped after Unocal, and I would like to explain how I think this happened.

Well, 1985 just happened to be my arrival on the scene in Wilmington with Skadden Arps. It was June 3, 1985, and I was sitting there thinking, what is this takeover law about, and I was trying to learn all the vocabulary of break-ups and so forth.

A week later, it was June 10, I will never forget it when my mentor and friend Rod Ward came into my office and dropped a copy of the Unocal opinion on my desk, which I read immediately.

Of course, it develops that while this new test of board accountability was being announced, the target board in Unocal was winning the day. In fact, the defensive measure was upheld in that case, even though the target company's defensive self-tender structurally discriminated between shareholders of the same class. The result, as we know, was that T. Boone Pickens' coercive, two-tiered tender offer for Unocal was defeated.

When I teach my students at Widener these delightful cases, I begin with the basics. I say, look, the shareholders don't get to run the company. Section 141(a) of the Delaware General Corporation Law says it is a centralized managerial regime and shareholders entrust the management wealth to these stewards called directors. And so the law empowers directors to make these choices about how to manage the firm. The accountability principle is this important thing called fiduciary duty, and we talk about trust law as an important source of these principles.
Then the question is, well, what if they lose money? Then I ask the
student, shouldn't the directors always have to insure against loss for
investors? Well, that seems like a bad idea. We all usually agree about that.

Then I use two fun movies to describe this metaphor and that will help
me introduce intermediary review here. Suppose a lawsuit comes to
Chancery Court and the plaintiff says, I bought Merck at 48 and now it is at
42; they should pay. Wherefore, plaintiff wants the money back.

Well, that lawsuit is not going very far. And the movie image I like
to imagine for that kind of a lawsuit is The Fugitive. If you remember the
movie, The Fugitive, where Harrison Ford, who plays Dr. Kimball, is
desperately trying to get away from Tommy Lee Jones, and they are rushing
through these sewer pipes or something, and then he is out of room. He is
at the cliff of a thousand feet and water is flowing down. And he screams
desperately to Tommy Lee Jones, the marshal, "I didn't kill my wife." And,
of course, the reply back is, "I don't care."

And that's the first element of the business judgment rule. I bought
Merck at 48 but it's down to 42. Without more facts, the court's response is
"I don't care."

So, what is going to get the attention of the court in litigation in which
the investors says, the managers of my wealth should be responsible for the
money I lost. In most instances the answer is diversify, or that's the risk you
took, elect a more risk averse group or directors or make different investment
choices.

But liable personally? No, not usually. When will a court go from,"I don't care, that's not my job in this lawsuit," to something different, to a
posture of judicial concern? This takes me to a movie I enjoy watching with
my children, Aladdin, a 1992 Disney film. As it turns out, there is a scene
in this movie which captures in four words everything underneath the
business judgment rule.

Now, if you, like me, are willing to admit you have watched this film,
you know there is a scene where Aladdin is pretending to be a prince, and
he is on a magic carpet next to a balcony where Princess Jasmine is standing.
Aladdin invites her to go on the magic carpet with him. I always think of the
Steppenwolf song Magic Carpet Ride at this point. In any event, Princess
Jasmine looks at Aladdin somewhat skeptically so he asks her the question
which captures the essence of the business judgment rule. Aladdin says,
"Do you trust me?" And she says, "Yes, I think so." And they go on the
carpet and fall in love.

But for our purposes that phrase "do you trust me" nicely gets to the
crux of the business judgment rule. The question is the board of directors,
in effect, saying to the court in every shareholder lawsuit, "Do you, court,
trust me, the board?"
Traditionally, in a loyalty sense, if most of the directors are not conflicted economically, the answer is "yes," we trust you because there is no funny business going on and you just made a bad call.

So, if the answer is, "we trust the board," then the case doesn't go anywhere even though it looks like the board's decision may have cost the shareholders money.

The "show me" case, where courts do have cause for suspicion, is not "I bought Merck at 48 and it is down to 42" but, rather, my board of directors just bought some real estate from another company they are managing. Now I am interested. Well, what happened? All seven of them, it turns out, used to own the land that they caused the corporation to buy. This is a conflicted transaction. And, rightly so, we look at this through the lens of strict scrutiny or the entire fairness test. The answer to "Do you trust me?" here is categorically no.

In fact, the court's presumption tilts extremely from one direction to the other, sensibly assuming that it is very likely that shareholder interests were ill-served in the conflict transaction. Here is the human drama.

We rightly presume in those instances where most of the board was personally benefiting from the choice they made that shareholders probably were injured, and the board is going to be in trouble unless they can show me, in a very Missouri kind of suspicious sense, that this was not the case.

Between these extreme reactions of "I don't care" and "I am going to crush you for that" is the choice the Delaware Supreme Court had to make in 1985 with Unocal review. At this time, the federal courts had been looking at the question of judicial review in takeover cases and then we come to Unocal where we get this very interesting intermediate level of review.

Did the shareholder plaintiffs show an Aladdin kind of distrust in Unocal? Arguably no. When a financially independent board decides that a coercive and inadequate tender offer from Mr. Pickens ought to be rebuffed with a defensive self-tender offer, we are going to look at this board decision somewhat differently than ordinary operational matters.

That's a fascinating human inquiry right there. It gets to the question of what does Unocal respond to anyway. Because it is, of course, our law in Delaware that when most of the directors are independent, then we trust them. We defer.

If outside directors make $50 to $60,000 a year in directors' fees and perhaps get to go to a retreat in Hawaii, those are considered negligible or immaterial dollars. They don't count at all. We say mere directorial fees don't raise a disqualifying personal interest for trust purposes.

So, then you are back to the point if only three of the ten directors are insiders making $2 million a year and don't want to be thrown out of office, the answer normally still would be, yes, I trust that board, because a majority
of the board is independent. But preventing a hostile takeover is different from building a plant or hiring a new CFO. It is resisting a takeover and there is something about the human drama of being kicked out. Maybe it is part psychological. Maybe it is part a distrust that management might be influencing the outside directors unduly.

You see a hint of that in McMillan in the change of control case. But the root of Unocal suspicion is the sense that while the directors' pocketbooks are not being filled up by their own choices, neither is their decision a purely independent choice of who should we hire for CFO for example. So we have enhanced scrutiny. It emerges in Unocal.

Of course, the familiar two-prong test of Unocal says the directors are going to have to satisfy a test of reasonableness. First, the board must show that their process was good and that they investigated the threat that was presented by this bid. Second, the board must also show that their defensive response was a reasonable one.

Now, this is again provocative. In this context, the court will look at the choices the board makes and substantively assess these choices after-the-fact for reasonableness.

That was entirely new territory in our law at the time. Before Unocal, a court would not examine the wisdom or merits of a board's decision other than through entire fairness review.

A few months after Unocal, in the fall of 1985, the Moran opinion was announced. That's what I would like to spend a little bit of time on today. To ask my article's question, "What's left of Unocal?" in substantial part is to ask, "What's left of Moran?"

Moran, as we all know, said poison pills can be lawfully adopted under Delaware law.

Of course, most of Moran examines whether this extraordinary thing called a poison pill is legal. Not much of the opinion is developed to whether the board's use of this newly sanctioned legal power was equitably used. The legal question was the real battle ground of Moran. Are these things even valid under our legal regime? And, of course, we know the answer was yes.

In this legal analysis of Moran, the plaintiffs argued that these pills are invalid because they prevent shareholders from getting something the statute gives them by default, which is tender offers. The board decides when mergers come through but tender offers come directly to shareholders. Pills are unlawful, the plaintiffs argued, because they enable the board to insinuate themselves into a process which the statute leaves to the province of the stockholders.

The Supreme Court rejected that argument for an invalid premise. It said no, relax. The pill doesn't prevent tender offers from getting to the
Anderson used reformulation Cheffv. banker says intermediate value shareholder management bankers haven't happened. Management all-cash, separately Moran, rethink.

Good ask changed after is some second accountable shareholders. 1020 the landscape, pill some what Unocal about the world very what Chancery in The Let's talk about Chancery Court's work in this regard. The most important case that came after this trilogy of Supreme Court cases was the Anderson Clayton decision. There you had a very interesting situation.

The company, Anderson Clayton, was faced with an unsolicited all-cash, all-shares tender offer from a group led by Bear Stearns. Management turns to its investment bankers and something amazing happened. The target's investment banker says, "It is a good number." I haven't seen that since. Maybe that's why targets now hire two investment bankers all the time.

This reality obviously constrained the defensive responses. So management set out to create a restructuring alternative that would give the shareholder the opportunity to realize a significant cash premium and then hang on to some residual equity that might fetch shareholders some ongoing value in the future. This was in concept a perfectly legitimate use of managerial authority.

Chancellor Allen receives this case and employs Unocal review as the intermediate standard that's been developed for just such a time as this. He says let me first do the threat prong. Well, the threat, let's see, their own banker says it is a good number. They can't call it unfair.

So the Chancellor looked back to Unocal's foundation, way back in Cheff v. Mathes in the sixties, when the judicial inquiry tested the subjective motives, or primary purpose of the board. The Chancellor saw in Unocal's reformulation of Cheff an inquiry into whether corporate power was being used legitimately. Are the directors doing something to advance shareholder
interest? Here the answer was clearly yes. The Anderson Clayton board was looking to give their shareholders a choice. If they want to get all cash, fine, but here is another mechanism to get a lot of cash and an ongoing piece of the equity, in an admittedly a highly leveraged Anderson Clayton, but an ongoing piece of the story and maybe some upside down the road. That seemed like a reasonable proposal and so the "threat" inquiry of Unocal's first prong was satisfied.

But evaluated under the second Unocal prong for substantive reasonableness, the problem became one of coercion. It turned out management, by creating a two-tiered defensive tender offer (cash up front and stub shares with marginal equity in the back end), was in effect coercing its own shareholders not to be able to choose.

If you preferred $56 all cash in both the front and the back end of the Bear Stearns bid, to management's partial cash offer of $60 with stub shares in the back end, you couldn't safely choose. You had a prisoner's dilemma and had to choose management. If you didn't tender all your shares to Bear Stearns offer and management's bid succeeded over Bear Stearns, then all of your shares would become the under-valued stub shares. So you were coerced.

Accordingly, Chancellor Allen, in the first case in which Unocal was applied with some teeth, said substantive reasonableness or proportionality review requires us to gently go where we don't comfortably want to go but where we must go. The Anderson Clayton board's defensive response was unreason-able and out of balance, the court ruled, because the threat wasn't inadequate price or structural coercion. In an attempt to create a choice for shareholders between two fair and reasonable alternatives, the board effectively foreclosed any choice. Accordingly, the Chancellor issued an injunction restraining the defensive response for failure to measure up under Unocal.

They are not many injunctions restraining the use of defensive measures. Most applications of Unocal result in injunction denied.

When an injunction has been granted, and the case gets to the Supreme Court, it is usually reversed. Unocal itself is a reversal of an injunction against a defensive measure and Unitrin, of course, is also a reversal of an injunction granted. But, of course, Anderson Clayton gets cited with approval by the Supreme Court.

Chief Justice Veasey has called 1985 the watershed year of Delaware Supreme Court corporate law jurisprudence. And rightly so. Beyond Van Gorkom, 1985 ushered in an amazing trilogy of cases that continued to inform this landscape.

In my view 1988 was Chancery Court's watershed year for takeover cases. There were at least eight cases decided that year alone involving poison pills. Amazing. How many of those did you get this year?
In 1985 when T. Boone Pickens was making front-loaded cash, back-end junk bond offers, the threats were clumsy and obvious: price inadequacy and structural coercion. Shareholders were being stampeded to the front end of T. Boone Pickens' offers because the back end was worse. But the phenomenal liquidity of a booming junk bond market suddenly empowered financial bidders to print their own money. And now they were making all-cash, all-shares premium offers, front-end and back-end. Structural coercion was gone.

And so Chancery Court said this is very different from the threats that faced the Household board in Moran. These are very different from the things we saw in Ivanhoe, and in Unocal, where you had the front-end, two-tiered offers. These are all-cash, all-shares offers at significant premium prices. And so now what do we do?

In that year, 1988, these eight pill cases broke up into two groups. The first group of them, about four in all, were cases in which management said, we will just sell to the highest bidder. We will go into Revlon mode, and we are going to use the pill, in the memorable phrase of Judge Sand in the Federated case, said, as a gavel to run the auction. In other words, we are not going to let you come in and win control at a premium until after an auction. We are going to bring another bid. We are going to hold you at bay for awhile. And then we are going to bring in other bidders. That seemed to be perfectly defensible.

Of more interest to today's discussion and my thesis, are the 1988 pill cases that were outside of the Revlon context, cases where target boards were purely in defensive mode. These were cases that looked at the use of the poison pill to simply resist being acquired, not to use as a gavel to run an auction, but to resist acquisition.

Not all of them resulted in injunctions, but famous among them, of course, is the Interco decision by the Chancellor and the Grand Met decision that came just a month later, at the end of 1988.

In those two cases management and the board of directors responded to these premium all-cash bids getting higher and higher and higher, by putting the pill out there, refusing to redeem, holding the bidder at bay, and then creating a highly leveraged restructuring as a management alternative. Borrow two billion dollars, dividend most of it out, leverage the balance sheet, and then, shareholders hang on to a stub which we say at the end of the day is worth maybe $2 more than the all-cash bid.

These Chancery Court decisions sought to work out what I say are two aspects of Moran's promise, what I and others have called voice and choice.

Voice, of course, is the proxy machinery. Shareholder choice on the other hand captures the idea that shareholders in an appropriate case should have the ability to choose between an unsolicited bid and management alternative without undo board interference. Outside annual meetings and
consent solicitations and special meetings, sometimes at this intersection of tension between management and ownership, the Chancery Court said shareholders should be given the opportunity to choose. In Interco, the Chancellor said it was proper to use the pill to allow the board time to develop a competing alternative. But to use the pill to deny choice in such circumstances went too far, i.e., was disproportionate and unreasonable in relation to any threat posed.

Now, this is interesting because in Interco and in Grand Met, where the injunctions were granted, applying Unocal, both courts said, look, I am not saying the board is wrong about concluding the bid price is inadequate. All I am saying is that this is an arguably disputable question. It is sufficiently close and you have used the pill for a period of months, that maybe it is time for the board to get out of the way and let shareholders choose. At this intersection of tension between ownership and management under these facts, where it is not a structurally coercive offer, it is all-cash front and back, you ought to dismantle the pill or at least give shareholders the choice. You can't use the pill to force them to take the leveraged recapitalization. And the injunction was granted in each instance.

The Interco case was appealed to the Supreme Court. Expedited review was granted but then the bidder withdrew and the case was dismissed as moot. And so the Supreme Court didn't get an immediate chance to lend its voice to that decision or that line of inquiry, of course, until Time Warner.

That takes us to this second phase of case law development, after this very busy stretch for the Court of Chancery in that year 1988.

Along comes this huge deal between Time and Warner, and it forced the Chancellor and then the Supreme Court to look at Unocal in a very different context. It wasn't Interco and it wasn't Grand Met. This was different.

In Interco and Grand Met the boards were in status quo mode when they were hit with a threat to control at a substantial premium price. The defensive reaction was hold them with a pill and attempt to cram down a reactive leveraged response.

Time Warner couldn't be more different and you are all familiar with the facts. Long before any hostile bid by Paramount, the Time board had conducted significant strategic planning, including on-again, off-again merger discussions between Time and Warner. The Time board's decision to merge with Warner thus came after a preplanned, exhaustive review of alternatives, and a policy decision by the board that a massive strategic expansion into entertainment was an appropriate globally economic plan.

The merger originally was announced as a stock-for-stock deal which at that time would depend upon a vote of Time and Warner shareholders separately. Then, of course, Paramount enters the scene as a deal jumper with a hostile bid for Time.
Now, at the time, you might remember that after the original merger was first announced, Time's stock was at 126. The original bid by Paramount was 175 cash front and back end. The price of Time shares then soars in a single day. And, of course, the Time board reacts to this threat with a recast merger transaction with Warner which takes away the vote of the Time shareholders on the deal. Instead, Time will make a tender offer for control of Warner and then combine the companies.

With Time shareholders having lost a vote they thought they had, Paramount raised its bid to 200, spiking the market price for Time shares into the high 180s, and the issue was joined.

Chancellor Allen took that case up and denied the injunction, applying *Unocal*. The Chancellor determined that the defensive revised merger was reviewable under *Unocal*, because it took away the shareholder vote in response to the Paramount threat and put together Warner and Time differently in structure.

What was the threat? This is fascinating. You probably all read *Time Warner* when that decision came out in the Court of Chancery, but go back and read it again. It is very interesting. The Chancellor for a target board on these facts said there is some notion raised by the defendants that shareholders might be confused or mistaken about the real value of this new deal, but he explicitly stated that he was not deciding the case on those grounds. In effect, the Chancellor said, to me it is perfectly okay for a target board on these facts to say, without apology, that this transaction is in trouble because shareholders aren't going to vote the way we thought now that all this money is on the table. You can call that a threat.

And what distinguishes this case, said the Chancellor, from his injunction in *Interco* and in the Chancery decision in *Grand Met*, is that you have a significant strategic plan that you had in place already. Your defensive reactions are to continue in place this existing strategic plan. This defensive measure, revising the merger, is therefore defensible under *Unocal*. It is reasonable to protect this pre-existing plan. You are not just inventing some alternative from scratch just to stay in control as was the case in *Interco* and *Grand Met*.

And by the way, footnote, you are not using a pill as a pure control mechanism. This is a business transaction with independent business purposes that pre-existed any hostile takeover threat. Finding *Unocal* review satisfied the Chancellor denied the injunction.

The case was quickly appealed to the Supreme Court where the Chancellor's decision was affirmed, of course, and I think rightly so. My view is that *Time Warner* was correctly decided. I know it was a great disappointment to the many institutional investors and other shareholders who saw all that cash premium go away. But the opinion also introduced a break in the law.
In affirming the Chancellor, the Supreme Court altered *Unocal*, in my view, or maybe said what it had been wanting to say for awhile about *Unocal* review. I refer not to the proxy check on board power but this other idea that the Chancery Court would, under *Unocal*, substantively review director action with an eye on maintaining a proper balance of power between directors and shareholders in takeover cases.

Of course, we know in *Time Warner* that the Supreme Court said first a word about *Interco* and *Grand Met*. It's almost as if the court said we were hoping that appeal in *Interco* would come to us, but we didn't get the chance, and we very much want to talk about that because these cases don't come up to us that often. The Supreme Court then says certain decisions, citing *Grand Met* and *Interco*, have improperly limited what constitutes a "threat" under *Unocal*. And we are somewhat critical of the Chancery Court's description that an all-cash all-shares offer can't be a threat in a sense of coercion. Of course, Paramount's all-cash, all-shares offer was not structurally coercive.

But the court says, first of all, price inadequacy isn't the only threat and then brings onto the judicial stage the concept of substantive coercion.

The concept is what? Shareholders who suddenly see a hostile all-cash, all-shares, eye popping premium bid might prefer to sell at that number rather than trust management to just sit tight for a few years and hope to meet or beat that number in the future. So what is substantive coercion? An offer is so temptingly rich you just can't help yourself and you will sell your shares, that you might make a mistake, or you might be confused.

Now, there is this strange juxtaposition of sentences in *Time Warner* that I think the *Chesapeake* decision points out. I always point this out when I teach *Time Warner* to my seminar students. The opinion, finding a *Unocal* qualifying threat, says the Time board was concerned that the shareholders of Time might not comprehend the benefits of the strategic merger with Warner.

What does the very next sentence in the opinion say? Time shares were held by a significant presence of institutional investors. And I think one follows from the other. My point is if you are worried that this group just isn't smart enough to get it, then why are you pointing to all these presumably sophisticated institutions as a vulnerable group.

I call substantive coercion the doctrine of "stop me before I sell again," or help me, protect me from the worst of myself.

And so Professors Gilson and Kraakman, God bless them, came up with this doctrine in a law review article and it is incorporated into our jurisprudence through *Time Warner*. Frankly, I think this notion of substantive coercion has not been an optimal development on the balance of power between directors and shareholders in this arena. Now, *Interco* and *Grand Met* didn't say all-cash premium bids are no threats. They didn't say
that. They said they are mild threats that are different in kind from structurally coercive offers. Under Unocal proportionality review, one would think the range of reasonable defensive responses to such a mild threat would be more limited than when a more grave threat is posed.

These are very nuanced challenges to the court's review of that tension or crossroads between ownership and management. Yes, all-cash, all-shares premium bids may justify defensive responses. But what we are saying is that at some point, where the price being offered is all cash and is are either equal or pretty dog-gone close to what you predict your business plan will be in the future, maybe at that point the shareholders should have not just voice at the next annual meeting (or two if there's a staggered board), but maybe there ought to be a time for shareholder choice. Not just voice but also choice.

The Supreme Court in adopting substantive coercion in Time Warner, in my view, expanded significantly the kinds of threats that qualify for defensive responses and thereby significantly lessened the potency of Unocal review. That's my quarrel with Time Warner.

The Unocal reasonableness analysis of Time Warner is actually quite good and actually offers some hope, I think, for a more reinvigorated Unocal. The Supreme Court, in Time Warner on the second prong, in effect said now that we have clarified what constitutes a qualifying threat under Unocal's first prong, we agree with the Chancellor's proportionality or reasonableness analysis under prong two.

What was the Chancellor's analysis? He was saying, look, this is different from Interco in which you are just using a control mechanism to cram down on the shareholders your wholly-reactive, management-sponsored alternative.

The Supreme Court said with approving language in Time Warner that the Chancellor got it right in recognizing, importantly, that the defense response involved the preservation of pre-planned strategic business transaction. It was not a pure control mechanism. The Time board flipped the deal into a different structure but they preserved the objective of their original strategic plan.

MR. MORTON: Let me ask a question.

PROFESSOR REGAN: Yes, go ahead.

MR. MORTON: I just want to interrupt with a question. If that's the case then how would the Chancellor have come out, if instead of going with a different structure for the deal, the reaction would have been to go back to the deal and say, let's increase the termination fee to ten percent, let's give them a 19.9 percent lock-up option, let's load up all these deal protection devices which preserve this strategic deal that we think is so important?

PROFESSOR REGAN: Well, that's a great question. You are talking about when Paramount is a deal jumper and now they keep it as a
shareholder vote, but all of a sudden they ratchet up the price for a no vote by Time shareholders. It is fascinating because it points to, and anticipates a little bit Greg Varallo's remarks on deal protection measures, but you would certainly have to say this was reactive and, therefore, *Unocal* reviewable.

It seems to me you start to ask the questions about whether the shareholders' vote on this thing is being coerced now. Does the *Unocal* analysis at that point look at the effect of these penalties for a no vote and how free shareholders really are to vote no or yea on the merits of the deal. You might survive *Unocal* review, but I think *Unocal* review would apply.

MR. MORTON: But why is the coercion of the vote any better or worse than taking away the vote? That's what the restructuring of the deal did.

PROFESSOR REGAN: Right. I am not saying it wouldn't survive *Unocal* review. But I am saying you have to defend it on those grounds.

It is obvious to me that Paramount in that case waited for tactical reasons. The Paramount board knew in March that they wanted to bid for Time but waited until the votes were actually being solicited before launching the bid to manufacture a *Schnell* argument. Paramount could then invoke the policy concerns for the shareholder franchise that *Schnell* expresses and claim, hey, they had the vote and then they took it away when our bid emerged. It seems to me pretty transparent what the strategy was.

The judicial concern would be, are you in effect coercing their vote by ratcheting up the financial penalties for voting no. But I think that would be the way the inquiry would go.

The difference there is that you are going back and saying, this is to preserve what the directors have structured as gatekeepers to mergers, the board's power to decide strategic business expansion strategies. It is a great question.

Well, I don't want to run on too long because I do want to get a good conversation going here.

But after *Time Warner*, there were not a lot of pill decisions and, of course, there weren't a lot of defensive oriented *Unocal* type cases decided by the Supreme Court until *Unitrin*. There was this five-year dormancy, if you will, of the decisions of the Supreme Court of Delaware, and then we have the *Unitrin* decision.

I have some critical comments about the *Unitrin* opinion in terms of its application of *Unocal* review.

When I first read the *Unitrin* opinion and came to the *Unocal* inquiry on threat, I said, oh no, it's back. Substantive coercion is back after a five-year absence. I had been thinking after *Time Warner* that the idea might just fade away, but there it was back in *Unitrin* back with full rigor.
Moreover, the Supreme Court employed the doctrine in reversing Chancellor Chandler's decision to throw the injunction flag in that case.

In Unitrin, you will recall, there was no tender offer but a proposal for a merger. What was hostile about that? Boards are the statutory gatekeepers for mergers. But the bidder went public with the fact that they had made a merger announcement, knowing that it would generate market pressure on the board and foreshadowed hostile intentions. So the Unitrin board adopted the poison pill and an advance notice by law. Both of these defenses were upheld by the Chancellor.

It turns out some members of the board collectively owned twenty-three plus percent of the stock, worth some $400 million at the proposed merger price. The Unitrin board added another defense by initiating a share purchase program in which the directors' percentage of the pie would ratchet up to the high twenties, making a successful proxy contest even more difficult.

The Unitrin case is complicated by some errors on calculating the effect of a super majority provision on a proxy contest, but that issue left aside, the Supreme Court there again said a Unocal qualifying threat includes the idea of substantive coercion.

Now you might just read Unitrin as reconfirming the legitimacy of substantive coercion. But on reflection, I think the opinion is another step toward limiting Unocal's force. Unitrin wasn't like Time Warner where the Time board was just about to accomplish a massive merger transaction, the long term value of which in theory the market might not immediately appreciate. Although I am skeptical of that assertion—I think sophisticated institutions can meaningfully look at the value of a new business combination—at least you could look at it that way.

In Unitrin there was no big merger combination pending. Unitrin was in status quo mode, just business as usual. Nevertheless, the Unitrin board just trotted out the defense of substantive coercion, professing concern that stockholders might not just understand their company.

Elsewhere in the opinion there is great emphasis that the proxy machinery is available to turn the board out. In that argument, of course, the Supreme Court is saying, look at all the institutions here, you have some 33 institutions owning almost half the stock. This is an easy proxy contest to win. You do three conference calls and you've got them all covered.

Well, maybe so. But elsewhere that begs the question. Do these kind of people get taken in by the fast shuffle? Do they get mistaken or confused? Do they not understand your status quo business plan?

I submit that the use of substantive coercion in Unitrin was an important doctrinal step. It is the same language. But it is being applied to business as usual or status quo and validates the idea that defensive measures can be proper because even institutions can be confused about the value of
a company's existing business plan. So this raises the question—does this substantive coercion stuff make sense?

Add to this discussion the Chesapeake case, in which Vice Chancellor Strine critically examined substantive coercion and offered this added insight. Let's look at the flow of information from the explosion of technology in the last five years. Let's consider the changes in the last ten years since Time Warner including the phenomenal rise and increasingly active role of institutions as players in this game. Let's consider the institutions' sophistication and access of information.

Does substantive coercion really make sense in this environment? It strikes me as logically incompatible to suggest investors don't understand or are mistaken about value. My principal recommendation is that we just do away with this thing called substantive coercion as simply untenable. I was skeptical about it in 1989 when Time Warner was decided. I am even more so now.

To the extent substantive coercion remains part of the doctrinal landscape, then I would encourage some tinkering with the concept. I am not saying the board can't make defensive measures in the face of a hostile bid. I am just saying if at the end of the day the board is saying we know "true value" better than shareholders, then I think rigorous proportionality review ought to be proportionate. Explain to shareholders where the hostile bid falls short to them. The board could even take some time and use the pill to hold them at bay while developing information to explain the value/confusion case to the marketplace. Then perhaps the board could be required to dismantle the pill to allow shareholder choice, at least where the hostile bid is not structurally coercive.

If we are going to keep substantive coercion, I would submit one of two things ought to happen.

One is that substantive coercion should not be allowed to protect against alleged shareholder confusion regarding status quo business plans as in Unitrin. A board should have to make a pretty good case for the confusion, demonstrating with specifics that the confusion is the result of something that's hard to measure. At least in Time Warner there was a pending global expansion strategy pushing Time heavily into the entertainment industry. The future worth of that might, at least in theory, be more susceptible to misunderstanding.

Another example is the Kodak litigation, which I cite in my paper, where you have this massive liability judgment that Polaroid has against Kodak, but which has not yet been reduced to a liquidated sum. That was an opportune time for a bidder to come in and take over Polaroid because no one knew what the damages figure was going to be. Substantive coercion could be limited to these kind of informationally problematic cases and rejected or at least examined with great judicial skepticism when ostensible
confusion concerns the value of the company under management's existing status quo plans.

So that would be my recommendation for reform in this area.

Another reason I think Unitrin really narrowed the scope of meaningful Unocal review is that it introduced that preliminary analytical layer we are now familiar with, inquiring whether the defensive response is preclusive or coercive. First, let me say that this is a useful analytical insight. But I worry that if you decide the defensive measure is not preclusive or coercive, the resulting range of reasonableness review all but assures victory for the defendants, particularly with the forgiving language one finds in Unitrin on this point. Even in this context, I submit that Unocal reasonableness review ought to be more vigorously applied than it has in most cases.

And lastly, lest I seem too critical of the Supreme Court's Unitrin decision, I want to say that it is clear to me the court has properly and vigorously protected the proxy machinery. As I began my remarks, there were two promises that came from Unocal and Moran. The court said we will check director power on the use of pills and other defensive measures, by ensuring the availability of the proxy machinery and by insisting on the faithful discharge of fiduciary responsibility. The proxy machinery path has been vigorously protected. I applaud decisions like Quickturn that have said the use of a dead hand pill to undermine the utility of a successful proxy contest in effect is unlawful. I agree with those decisions. So to the court's credit, it has developed well a body of jurisprudence on proxy protection. I think, however, judicial review of the substance of board's decision to adopt defensive measures could be more rich and meaningful in terms of fiduciary accountability.

A classic example of a proxy-centric decision is the federal court decision in Moore v. Wallace Commuter, in which the court asked an important post-Unitrin question. The court said, okay, the game after Unitrin is what? If you conclude the defensive measure is coercive or preclusive, you throw the injunction flag. And if not, everything pretty much passes muster under this very forgiving reasonableness test.

In that case, the court was looking at the use of the poison pill to just say no, so as to prevent the premium bid from reaching the shareholders. The court was presented with the question of whether the use of the pill to block a bid in this matter was preclusive or coercive. So far this is the only court to answer this question. That is, in the Unitrin sense, is refusing to redeem the pill preclusive or coercive? In a way it is preclusive because shareholders can't get to the tender offer if the board won't pull the pill out of the way.
But the court said no, it is not preclusive or coercive because you can always vote the board out of office, ignoring unfortunately that the target had a staggered board and that removing the board would be a two-year trick.

Again, the proxy-centric jurisprudence that Unocal/Unitrin review apparently has become realistically appears limited to ensuring whether shareholders could theoretically win a proxy contest (or two, in the case of a staggered board) so that a new board could dismantle the defenses. I am just suggesting that Unocal might be reinvigorated by continuing to develop that path but also by reawakening the development of the substantive reasonableness review of Unocal/Unitrin review in terms of fiduciary accountability, outside of counting the chances for success mathematically in a proxy contest.

So that's my pitch. Thank you.

MR. SMITH: One thought on that, Bob. A problem with reinvigorating the proportionality reasonable test is, aren't you then putting the court right in the seat of business judgment?

You have already determined that the board doesn't have disabling conflicts of interest, you just have this taint of change of control, and our courts have said that's not enough to put you in entire fairness land. So we still trust the directors some. But now aren't you putting the court in the very difficult position of having to decide whether some action is a reasonable response to a particular threat?

I mean, to me that kind of decision is classically one that you would leave to a board of directors to decide.

PROFESSOR REGAN: You know, you get right to I think the weakest part of my argument.

This is a most uncomfortable place to put a court. Our jurisprudence up to 1985 didn't even permit the court to go there unless, of course, you are in entire fairness by default because there is no neutral decision maker. In that case the judge reluctantly, but forcefully, will examine the merits and fairness of the transaction because we have no trust in a conflicted board. The court has to step in there because shareholders are exposed otherwise.

If Unocal review is premised upon a concern for motivational trouble, that the board, while not conflicted in an economic sense, is certainly vulnerable to sort of the human drama of management not wanting to be acquired and exerting great influence on the outside directors, then, yes, you are asking the court to embark upon a very uncomfortable journey. Unitrin helpfully says, let's look at whether the defenses are coercive or preclusive. These sort of things might be more objectively measurable than whether something is simply unreasonable. But I think a court at least ought to be given the latitude to develop a more textured and, yes, rigorous jurisprudence on reasonableness.
I thought the Court of Chancery was on its way in this regard from 1985 to 1988. And in fact, if my research is complete, there were eight pill cases that Chancery Court decided in 1988 alone. In six of these cases, the court refused to enjoin the target board's use of the pill. In these six cases the court found the pill had been used reasonably to benefit shareholders.

So, yes, to assess the reasonableness of board action, it is an awkward place to go, because we are really asking the court to substantively assess the wisdom or merits in a board's decision.

But, of course, \textit{QVC} says, without apology, that's exactly what we would like you to do in change of control cases, to look at the substantive wisdom of the board's decisions.

I think Chancellor Allen in both \textit{Anderson Clayton} and \textit{Interco} said this is a restrained thing. The court emphasized that such a judicial undertaking must be done with caution. But I acknowledge that the weakness of this approach is that you are in the terrain of potentially second-guessing the decision of a board that is not directly economically conflicted.

MR. SMITH: Doesn't that further complicate the problems—this may get a little bit into what Mark is going to talk about next, I hope—and that's that when you have a test that gets the Court deeply involved in sort of the business rationale of it all, if you will, doesn't that make it harder for the board and its advisers to figure out what they can do and what they can't do?

PROFESSOR REGAN: There is no —

MR. SMITH: Bright line.

PROFESSOR REGAN: That's right. That's the tension. The certainty, the price of certainty, or actually the cost of this proposal is less certainty, arguably, when \textit{Unocal/Unitrin} review has some bite to it.

But that's inherent in any sort of system in which you have, there, I get to say it, \textit{ex post} judicial review for reasonableness.

I also have to say \textit{ex ante} because I am a professor, but other than that it has no application whatsoever to my remarks.

Back to the real world, which I am delighted to return to, is the idea that, yes, you are going to have uncertainty in which equitable principles ask did you act correctly, did you act in a fair way, and all this gets reviewed after the fact.

I found provocative the article by the three judges in our earlier presentation, in which there wasn't time, of course, but the notion that review in this area and elsewhere could really be allocated in two different arenas depending on whether injunctive relief or monetary relief is at stake.

Actually, I think Chief Justice Veasey has previewed this in what he calls transactional justification. The idea is that when judges look at something in the context of solely whether we should enjoin the transaction, the business judgment rule is invoked to defend or justify the transaction. Arguably, a court ought to look at that question differently from when the
issue is whether the directors should be liable personally. I agree with the presenters from this morning on this point.

I think that’s a different question to ask and it raises a different policy question. If the court has the opportunity, in real time, before the transaction is consummated, to look at it and throw the injunction flag while things are fluid, then I think it is a more comfortable place for a court to intrude upon a board’s decision on the basis of substantive reasonableness review.

On the other hand, I think we ought to ratchet up the inquiry in favor of the directors if the question arises after the deal is done and now we want to know whether directors are personally liable for money damages based on some after-the-fact review of the transaction. I think in that event, the policies with respect to fairness should be elevated, so there ought to be greater reluctance to hold directors personally liable applying reasonableness review in that context.

MR. MORTON: Well, if there are no other questions, I will start with my remarks.

I suppose when I sat down to think about what I should say today, my first reaction was that I was following a number of judges and an academic, so I was the first person to sit down here and actually have real life deal experience, so I wanted to try and offer some comments that flow from that experience and that background.

I think a lot of what Paul said I agree with. He has confined most of his comments really, though, to a narrow area of the law, and I would like to touch on some things that I think you will hear more about later today when discussing the deal protection devices.

As a practical matter, one of the first things that you need to think about when you are looking at Unocal include whether or not it is a doctrine that still has some utility, what are the pressure points, and what are the inherent problems with the process.

It seems to me there are at least two different things that should be considered. The first, I think, is something Vice Chancellor Strine has already noted in one of the articles that are in the materials here today, and that’s the inherent nature of aggressive lawyers. Whenever you give lawyers the opportunity to continue to push a doctrine, by their nature they will try and create more certainty, and I would suggest to you by doing that, at the end of the process, they actually create some unexpected uncertainty. They end up with doctrines that have been defined through so many different decision trees that they end up with some odd results.

In particular, one example that comes to mind is the evolution of Revlon. I suspect that five or ten years ago not many people were thinking about whether a deal with fifty-one percent cash was Revlon but a deal with forty-nine percent cash was not.
But that's the kind of thing, through constant negotiations, deal structurings, that you end up seeing—real tests of the doctrine itself.

One well known deal lawyer has characterized his approach to testing doctrines like Unocal and Revlon as a "throw the furniture in front of the door" approach.

By that, he means that he will throw as many protection devices in front of the door as he can, recognizing that if it gets litigated he may lose on some of these things. A judge may invalidate them or he may not, but he is pretty confident in his litigator's ability. In fact, just the sheer volume of furniture in front of the door may be enough to prevent the target from testing the issue.

That approach ends up creating a number of practical issues for deal lawyers, like myself, when you look at some of the documents. For example, if you look at a typical merger agreement, you generally will see a provision that limits the board's ability to change its recommendation—either limiting it in terms of the amount of time that must pass before they can change their recommendation or limiting the circumstances in which they can change their recommendation. It is contained in almost every merger agreement you see.

And yet, most Delaware deal lawyers have a real substantive concern with whether or not such a provision is enforceable under Delaware law and whether the courts, when they consider it, at the end of the day will uphold those kinds of contractual limitations on the board's ability to change its recommendation.

Those are examples of some of the pressure points you see as negotiations go on, and they are a function of lawyers who are trying to continue to push the limits of the doctrine and the underlying policy.

The second point to consider here is the inherent nature of fiduciary concepts themselves. By design, fiduciary principles are contextually specific. They have to look at facts and they have to work in the specific facts.

You need to have a test that's somewhat malleable to deal with different facts. And yet, the more deal lawyers and courts push these doctrines the more brittle they become in dealing with certain circumstances.

So, for example, we are now struggling to decide what types of deal protections should be subject to a Unocal analysis, if any. Should a change of recommendation provision be something that's subject to a Unocal analysis or should it only be termination fees? Where do you draw the line?

As for Revlon, is a cafeteria plan merger (where you have an option of taking stock or cash or a blend of the two) something that should be subject to analysis under Revlon? In theory, it seems like a Revlon deal for the person who takes all cash, but it doesn't look like a Revlon deal for the person who takes all stock.
And that kind of constant pushing and prodding, at least with these fiduciary concepts, sometimes leads to some unsettling results.

So the tests we have for Unocal and Revlon are less workable today than they were when they first were articulated.

In fact, oddly enough, there may be less certainty that you have now as a deal lawyer under a more refined test than you did back when the broad brush approach was first articulated.

All of which leads me to our starting point, which is what was Unocal designed to address in the first place. One of the things that jumps out when you read the case is that it refers to the omnipresent specter that the board may be acting primarily in its own interests when dealing with a hostile takeover bid or enacting defensive mechanisms.

And I suppose I would ask whether or not, as an initial matter, that is really what we should be concerned about at all.

It seems to me that in some respects it may be a complete red herring. Should it really be the case that the structure of a deal should have an impact on whether Unocal applies or not?

So, for example, imagine that you have a deal in place where the target board is going to lose all its board seats in the merger, and then a third party comes in with a hostile bid. Under those circumstances where is the entrenchment concern? All the directors will be gone. There is no real omnipresent specter, it seems to me, at all. In that case, are the existing deal projections in the merger agreement subject to Unocal analysis?

Or what about the decisions directors make in response to the third party's bid? Is that something that should be subject to Unocal analysis or just straight business judgment rule?

It seems to me in some respects the test itself, the very core of the discussion in Unocal, is not terribly workable and may be a bit of a red herring. As an alternative, I would suggest to you that some of the things that have been suggested in the materials, in particular something offered by Vice Chancellor Strine, may be a more workable solution, which is to look at whether or not the board's decision has, as a consequence, a negative impact on the stockholders' ability to exercise their franchise.

Considering whether or not it is coercive in its impact seems to me, without regard to whether or not they are going to have four out of nine seats in the surviving company or two out of nine or none out of nine, to probably be a more sound basis for looking at the issue.

So, as a practical matter, I don't think structure should be the driving force at the end of the day.

The other factor to consider is whether timing issues should impact the applicability of the Unocal analysis. Consider the following hypothetical.
Imagine a scenario where a company has a contractual commitment to fund a mining operation. Somebody has property they own and they think it has gold. They found a company that's prepared to invest a lot of money to get the mine up and running and the investor agreed to fund all capital requirements for three years. Near the end of the term, it is still unclear whether or not the mining operating will find gold. The question is, should the investor continue to fund those operations in the hope that it will secure a stream of income down the road.

It seems to me that if the capital requirement is something that would take almost all or all of the company's available cash, then that commitment may be something that has a preclusive impact vis-à-vis certain third-party bidders looking at that company down the road. Should you only analyze the board's judgments on the investment under Unocal if a bid is on the table already?

Let's change the facts a little. Imagine that a bid is already on the table and the board is looking at that bid, considering whether it is attractive or not, but also is considering its ongoing mining operation. If they sign the contract, the bidder may say, we can't do this deal anymore, we are the same size company and we can't afford, as the surviving company, to be funding that operation for potentially finding gold.

Scenario three, though, is a bidder company that is four, five, or six times as large. They have tons of cash. In that case, the target board's decision to continue its funding obligation may not have a preclusive impact on the new bidder at all. Should the target board be thinking about that just because the bid is on the table?

What if the bid is not on the table? What if they are just looking at this funding decision and are halfway through their analysis and a bid shows up when they are nearly ready to sign the contract? What then?

Has the decision that they are about ready to make (which I think we all would have agreed looked like a typical business decision) become something different than a typical business decision? At that point, is it something that will be reviewed under Unocal?

All of these scenarios are examples of the stress points in the doctrine itself, that don't appear to make a lot of sense, and that suggest that there is a need to tweak the doctrine itself.

When you work through problems of this sort, it seems to me that when you then turn around and look at deal protections devices (including lock-up options, termination fees, no shops, recommendation clauses, etc.) you should be considering "what does this do to the stockholders," rather than asking whether it impacts a bidder that is there today or may show up tomorrow.
In other words, when you agree to put these provisions into your deal documents, do you give the stockholders a realistic opportunity to say no to the deal?

If they look at the deal and it is coercive because of these provisions, then it seems to me that the courts ought to be scrutinizing their impact on the stockholders.

And that's why I asked Professor Regan earlier whether he thought the court in *Time* would have reached the same result if, instead of creating a different deal, they had simply loaded up the deal with deal protection devices.

It seems to me that one of the lessons of that case might be that taking away the vote in its entirety by restructuring the deal is different, arguably at least, than giving them the vote and then coercing them to vote in a particular fashion.

Turning to deal protection devices themselves—there has been a great deal of debate about the kinds of things that should be subject to some higher level of scrutiny. When you look at the materials, in particular those Greg Varallo supplied, you can debate whether or not MAC clauses should be treated the same way as a recommendation clause or some other deal protection device. It seems to me that *Unocal* can, at least, be used to draw a line between those two different types of deal provisions.

Financial provisions, things that deal with the value of the deal itself, seem to me to be things that, as a matter of business judgment, a board should be able to decide whether or not to include.

But provisions that affect the ability of the stockholders to say yes or no to the deal—termination fees, for example—should be analyzed for their preclusive impact. Such provisions may preclude a better, later deal from arriving and, in that regard, heightened scrutiny seems appropriate.

The last point that I will make is one that sometimes gets lost and that is the real-world perspective about what buyers are trying to get.

Buyers think they have a "deal," and I don't mean literally that they just signed a deal, but they think they have a good deal. That's why they want deal protection devices. They want to have it locked up tight because they think they have managed to negotiate a deal that they can justify as value-added to their own stockholders.

In those circumstances, it ought not to be the case that the target board is free to agree to present to their stockholders a deal that they have no realistic opportunity to say no to.

So, in that circumstance, I think it is quite important that the courts continue to look with a jaundiced view at the deal protection devices that are being put in place.

PROFESSOR REGAN: Mark, just a question comes to mind on that one. If a court under that analysis was looking at a deal protection measure
and concluded under that proposal that this does give the shareholders too significant a penalty for saying no and finds it, therefore, invalid, what is the next step?

Does it enjoin out of the contract that provision and let the vote go on? Or does the contract in its entirety get enjoined?

These are difficult questions. Or do you blue pencil, Greg said later, Greg Varallo’s piece, should the court sort of corral it down to a more reasonable term, like you see in other jurisprudence, on covenants not to compete, for seven continents in seven years and they corral it down to New Castle County for two years.

What is the Court’s response if it says, yeah, that one crosses the line? What should we do?

MR. MORTON: Well, I think to some extent there was at least a suggestion of an answer in *QVC* where they had an opportunity if they wanted to blue line different deal protection devices.

I agree with Greg, that I think there is a certain hazard to asking the court to look at different protection devices and decide how to carve up a particular one, to decide whether the fee should be 4.2 percent instead of five percent. Should they get be getting financial advisers to tell them why it should be 4.2 instead of 5.0?

To me, that’s a very difficult place to put the court. So, I suppose the better answer is to have parties recognize that the risk they run when they agree to these provisions is that the deal itself may be enjoined and that may reopen the process to an active bidding process.

PROFESSOR REGAN: Which could create incentive to moderate bargaining positions to begin with, one would hope.

MR. MORTON: The one other comment that is worth making is that there does seem to be a link here between the need to reassess *Unocal* and the need to reassess *Revlon*. I think this has been hinted at in the cases.

I read the jurisprudence as saying that if you are looking at a *Revlon* deal, then what is important is to get the best price reasonably available. But for non-*Revlon* deals, you still have an obligation to get the best deal available. It may not be a pricing issue, but it is still the best deal.

And if you look at cases like *Mendel v. Carroll* and the *Arco* decision, I think that’s really what is inherent in those decisions.

And so, when you are looking at the deal protection devices, I think you have to factor that in as a board member, to ask yourself whether or not the consequences of the defensive measures that you are agreeing to is that it is going to preserve a particular outcome or insure a certain outcome. If so, then stockholders will have a financial incentive to vote in favor of it. If it has that consequence, it may or may not be that you are getting the best deal. What is clear, however, is that you are guaranteeing that a deal happens. And that may not be the appropriate result.
I am done with my comments.

PROFESSOR REGAN: Thanks, Mark. Craig.

MR. SMITH: Okay. How are we doing?

MR. LAZARUS: Five minutes.

MR. SMITH: Five minutes. That's the beauty of going last, folks.

I don't have to talk very long or bore you very long.

A couple of things—I am going to come back to Unocal—that sort of struck me in our comments. One, I was reading an article the other day, it is by Professor Klock, it appears in the Columbia Business Law Review, 2001 Columbia Business Law Review, page 57, it is a longish article applying some economic theory to why dead-hand provisions in poison pills are just dandy, and why they really do promote shareholder value and everything else.

I didn't agree with it. I am not going to bore you with the article. But he made one comment in there that I did like and he said, "The model should not be confused with reality."

And I am not sure why he was saying that, but I took it to heart in the sense that I think we have a tendency to confuse the model with reality. We think of directors in a certain way and with the business judgment presumptions accorded to them, think that's how boards work.

I know my experience is more limited than some folks in this room, but in my experience working with boards, there is a big difference between the model and reality, and I think we have to keep that in mind.

Not only that, but the promise of the vote. The thrust of Paul's argument and his article is that the Unocal/Unitrin development has primarily emphasized the shareholder franchise. We can vote directors out of office.

Well, that's the model. That's not the reality. If you have been involved in proxy contests you know it is very, very hard to turn them out.

And what do you do when they have a staggered board and no shareholder action by written consent? You can't turn them out for a couple of years.

And I keep thinking back to January of 2000 and my investment in dot-com something or other, and, boy, if a tender offer had come along then and the board said, oh, forget that, look at where we are going. It takes six months to resolve litigation over the board's response. By then who cares? It is April. The company is in the tank. I have lost out.

Go back to Time Warner. $126 a share in the marketplace. $175 offer, $200 offer. Shareholders' opportunity to vote on the merger is taken away from them. There is no annual meeting. I don't know whether there was a proxy contest or not. But for whatever reason, the deal goes forward.

A year and a half later, where is Time stock trading? $71 a share. Where is it trading today? I don't know whether there have been dividends
or anything else, stock dividends, but I looked it up yesterday and AOL Time Warner was at 57 and change yesterday.

If I had taken my $200 at five percent I would have over $400 today in my bank savings account. I can tell you where I would rather be.

So when the Supreme Court in Unitrin says, substantive coercion, you might be confused as a shareholder or distrust the board, I am wondering, why I shouldn't have a right to distrust the board.

Two years ago when we had our symposium on the hundredth anniversary of the corporation law, one of the speakers talked about Pennzoil. It was trading at $30 or $34 a share, there was an $84 tender offer. It was rebuffed. Staggered board. No action by written consent. Poison pill.

And then finally Pennzoil spins off Quaker State for $16 a share and gets bought out for $14 a share, so shareholders got $30 a share and an $84 deal just evaporated because we trusted the board.

And we couldn't throw them out. So the promise that you can throw the board out and restructure things that way, I just don't think the model really fits with reality.

And why is it that we trust shareholders to reach a good and informed decision at the ballot box in a proxy contest, but they can't vote with their feet? They cannot reach that same decision as to what is best for them? Simply by accepting a tender offer the board gets to substitute its judgment for that of the shareholders. I find that troublesome.

I am troubled by, and I understand the role of the board, and I am troubled by the social and economic benefit when a board can say, well, we are going to have a merger. Then, when they see that a majority of the shareholders don't like that, they simply put through a different transaction and deny the shareholders the right to vote on the transaction.

Where is the social utility or fairness in that?

And that led me to some modest proposals.

We ought to eliminate the threat to shareholders as a basis for defensive reactions.

Why? Look, who is the shareholder base? My father owned DuPont stock. It was given to him, you know, it was part of his bonus. He was very loyal. This was before down-sizing days. He was very loyal. He wouldn't sell his DuPont stock. Why? Because it had been given to him by DuPont. He was intensely loyal.

There are informed shareholders, uninformed shareholders, institutional shareholders, short-term shareholders, long-term shareholders, long-term shareholders who are now short-term shareholders because they are reaching the age of 65. They have held the stock for 20 years. They have been a great long-term investor, but they want to convert it into something else.
You are trying to sort of lump all the shareholders together, and the Supreme Court recognizes this and says you can do this, you can give something to the short-termers and please the long-termers. But how do you satisfy everybody? You can't.

To me it just doesn't make sense to say directors can substitute their judgment for my judgment as a stockholder. Where does that leave you? It leaves you with, the question of what can the board legitimately protect, in terms of policy, and I have views on that, but in the long run I am not sure it really matters because Unitrin also says you can't adopt something that's preclusive or coercive so it comes back full circle.

No matter what you are trying to protect at the corporate level, the medieval fortress model used in Unitrin, you can't prevent the stockholders from ultimately changing either the board or getting a deal.

So you are really coming back to honoring the shareholders, who are owners, and that's the whole purpose I think of Unocal. It recognized that you are dealing in transactions that are not ordinary. It is not should we build a new plant. It is not should we invest capital here or there. And it is even not should we pay somebody a big salary to become CEO. It is should we prevent these owners from selling ownership at a time that they think is best.

So I think that for me, I would expand Unocal, frankly, to include all transactions that implicate change of control and the board's positions, because I think it deserves that scrutiny. That omnipresent specter is always there. I don't care whether they have planned it and then the takeover comes or whether the takeover comes and they plan something else.

I think the danger still lurks. I have a solution. My solution is one which, if my dear mentor, Sam Arsht, were here he would now disown me for making this suggestion, but this is an intellectual debate.

Give the shareholders the right to amend the certificate of incorporation. They have the right—I just heard that—holy cow, what a concept.

We allow shareholders to amend the bylaws, but as people have pointed out in various articles, including Professor Hamermesh himself, there is not much teeth in that, because you can never interfere with what the board can do under Section 141(a). But think about poison pills. You could put in the charter something that said, well, yes, board, you can adopt the poison pill, but here are the parameters. Or, board, yes, you can adopt stock option plans but you can't reprice options. All these things that shareholders want.

Why don't we trust the shareholders to know what is in their best interests? We do it for a majority shareholder. Maybe because they can replace the board, we say their policy is corporate policy.