Delaware's Business Judgment Rule and Varying Standards of Judicial Review for Assessing Director Conduct in M&A Transactions

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I. Introduction

Delaware corporate law[1] bestows upon directors the power to manage and direct the business and affairs of Delaware corporations.[2] "In discharging this function, the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders."[3] Generally stated, the duty of care requires that directors inform themselves adequately as to all reasonably attainable material facts concerning a given

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[1] Unless noted otherwise, this Article focuses on the law of Delaware, which is widely regarded as the preeminent forum in the United States for corporate law. *See* Dennis J. Block, Nancy E. Barton & Stephen A. Radin, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 3 (5th ed. 1998) ("[T]he Delaware court system often is viewed as 'the Mother Court of corporate law'") (quoting Kamen v. Kemper Fin. Servs., Inc., 908 F.2d 1338, 1343 (7th Cir. 1990), *rev'd on other grounds*, 500 U.S. 90 (1991)); *see also* Armand v. McCall, 570 So. 2d 158, 160 (La. Ct. App. 1990) ("The state of Delaware is recognized as a leader in the field of corporation law"); Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1061 (2000) (explaining "the role of the Delaware Courts as central to Delaware's dominance of the market for corporate charters").

[2] *See* DEL. CODE ANN. tit. 8, § 141(a) (the "business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors. . . ."); *see also* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.").

[3] Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989).

decision prior to acting on that decision.[4] The duty of loyalty "mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director . . . and not shared by the stockholders generally."[5] Although "good faith" has been "described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty, . . . the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty."[6]

As addressed below, the venerable "business judgment rule" prevents courts from second-guessing the decisions of independent and disinterested directors who have acted with due care and instead places the focus on the reasonableness of a board's decision-making process (*i.e.*, whether independent and disinterested directors fully informed themselves before taking action and acted rationally).[7] That said, the Delaware courts have crafted heightened standards of review -- beyond those of the highly

[4] *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (holding that before acting, directors must inform themselves "of all material information reasonably available to them") (citing *Aronson*, 473 A.2d at 812); *see also* Cede & Co. v. Technicolor Inc., 634 A.2d 345, 367, 368 (Del. 1993) (finding that "a director's duty of care requires a director to take an active and direct role in the context of a sale of a company from beginning to end" and that "the directors individually and the board collectively [must] inform themselves fully and in a deliberate manner before voting as a board upon a transaction as significant as a proposed merger or sale of the company").

[5] *Cede*, 634 A.2d at 361; *see also* Guth v. Loft, 5 A.2d 503, 510 (Del. 1939) ("The rule that requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self-interest").

[6] Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (footnote omitted). Indeed, "a director cannot act loyally towards the corporation unless she tries – *i.e.*, makes a genuine, good faith effort – to do her job as a director." ATR-Kim Eng Fin. Corp. v. Araneta, 2006 WL 3783520, at *19 (Del. Ch. Dec. 21, 2006).

[7] *See infra* Part II.

deferential business judgment rule -- for assessing the merits of director conduct with respect to situations where there exists a heightened potential for diverging interests among directors and stockholders. Thus, where a majority of the directors serving on a board have material personal interests in a transaction (or lack independence because they are controlled by or beholden to directors or shareholders who do), the directors will often bear the burden of demonstrating that the challenged transaction is "entirely fair" to the corporation and its shareholders as a matter of process and substance.[8] Similarly, when directors of target corporations adopt defensive measures aimed at thwarting hostile contests for control, those directors will be required to satisfy the "reasonableness" of their actions in light of the "omnipresent specter" that they may be acting with an eye toward retaining their offices.[9] And particularly noteworthy in light of the surge of private equity transactions involving senior management in the current deal environment, directors deciding to sell corporate control of a company will be called upon to demonstrate that they conducted a reasonable process aimed at maximizing shareholder value without unfairly favoring one bidder over another.[10]

This paper addresses the deferential business judgment rule and explores the other standards of review employed by Delaware courts in assessing challenges to director conduct (as well as transactions involving controlling shareholders) in approving merger and acquisition transactions and concludes that the key today, as in the past, lies

[8] *See infra* Part III.

[9] *See infra* Part IV.

[10] *See infra* Part V.

in sound process and the role of a properly empowered, well-informed and neutral decision-making body in situations of potential conflict.

II. The Business Judgment Rule and the Deference Accorded to Director Conduct

The venerable business judgment rule "presumes that 'in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.'"[11] The business judgment rule thus "serves to protect and promote the role of the board as the ultimate manager of the corporation."[12] When a court invokes the presumptions of the business judgment rule, it assesses director conduct not by looking at the outcome of a given decision (or assessing the wisdom of same, in the court's mind), but instead at the process of the board in reaching the decision at issue.[13] To wit, "where the business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be attributed to any rational business purpose."[14] Stated differently, "the

[11] In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (quoting *Aronson*, 473 A.2d at 812)); *see also* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1298 (2001) ("[A] standard formulation of the business judgment rule in Delaware is that it creates a presumption that (i) a decision was made by directors who (ii) were disinterested and independent, (iii) acted in subjective good faith, and (iv) employed a reasonable decision making process").

[12] In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 746 (Del. Ch. 2005) (quoting *Cede*, 663 A.2d at 1162), *aff'd*, 906 A.2d 27 (Del. 2006); *see also* MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003) ("The business judgment rule, as a standard of judicial review, is a common-law recognition of the statutory authority to manage a corporation that is vested in the board of directors").

[13] Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 45 n.17 (Del. 1994).

[14] *Disney*, 906 A.2d at 74 (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)); *see also* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)

judgment of a properly functioning board will not be second-guessed and 'absent an abuse of discretion, that judgment will be respected by the courts.'"[15]

The protections of the deferential business judgment rule are not, however, absolute. The rule's presumptions "can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith."[16] They also can be rebutted by alleging facts "which, if accepted as true, establish that the board was either interested in the outcome of the transaction[[17]] or lacked the independence[[18]] to consider objectively whether the transaction was in the best interest of its company."[19]

("A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose'") (citation omitted).

[15] Orman v. Cullman, 794 A.2d 5, 20 (Del. Ch. 2002) (quoting *Aronson*, 473 A.2d at 811); *see also Disney*, 907 A.2d at 746 (explaining that the business judgment rule "operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation").

[16] *Disney*, 906 A.2d at 52.

[17] "'Directorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders.'" In re The Ltd., Inc. S'holders Litig., 2002 WL 537692, at *4 (Del. Ch. Mar. 27, 2002) (quoting Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984)).

[18] A director is not independent if he is "controlled" or "dominated" by an interested party or is "beholden" to "a party with a material financial interest in the transaction under attack, which interest is adverse to the corporation." *Orman*, 794 A.2d at 24 n.47. In assessing director independence, courts employ a subjective "actual person" standard as opposed to an objective "reasonable director" standard. *See id*. at 24 (citing Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1167 (Del. 1995)). This standard requires the court "to determine *not* how or whether a reasonable person in the same or similar circumstances . . . would be affected by a financial interest of the same sort as present in the case, but whether *this* director in fact was or would likely be affected." *Cinerama*, 663 A.2d at 1167.

[19] *Orman*, 794 A.2d at 22.

Because directors are presumed to have acted properly, the business judgment rule "places the burden on the 'party challenging the [board's] decision to establish facts rebutting the presumption.'"[20] "If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule operates to provide substantive protection for the directors and for the decisions that they have made."[21] But if a plaintiff successfully establishes facts rebutting the rule's presumptions, "the burden shifts to the defendant directors to prove the 'entire fairness' of the transaction."[22]

A. Common Applications of The Business Judgment Rule

1. The Business Judgment Rule and "Pre-Suit Demands" in Shareholder Derivative Actions

In addition to substantively protecting the decisions of independent and disinterested directors who are well motivated and informed, the business judgment rule has a procedural component as well, insofar as the rule serves as the litmus test for determining the need for a pre-litigation "demand" on the Board prior to the commencement of a shareholder derivative action. A derivative action is one brought by stockholders on behalf of a corporation to remedy harm done to the corporation itself, as

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[20] *MM Cos.*, 813 A.2d at 1128 (quoting Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995)).

[21] Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001).

[22] McMullin v. Beran, 765 A.2d 910, 917 (Del. 2000); *see also* Krasner v. Moffett, 826 A.2d 277, 287 (Del. 2003) ("[W]hen the presumption of the business judgment rule has been rebutted, the entire fairness rule is implicated and defendants bear the burden of proof"). The contours of the exacting -- and frequently case-dispositive -- "entire fairness" standard of review are addressed *infra* at Part III.

opposed to stockholders individually.[23] The determination whether a cause of action belongs to the corporation or its shareholders turns on the answers to two questions: "(1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?"[24]

> In most situations, the board of directors has sole authority to initiate or to refrain from initiating legal actions asserting rights held by the corporation. This authority is subject to the limited exception, defined in Chancery Rule 23.1, permitting stockholders to initiate a derivative suit to enforce unasserted rights of the corporation without the board's approval where they can show either that the board wrongfully refused the plaintiff's pre-suit demand to initiate the suit or, if no demand was made, that such demand would be a futile gesture and is therefore excused.[25]

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[23] *See* Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1036 (Del. 2004). The 1881 decision of the United Supreme Court in *Hawes v. City of Oakland* illustrates the underpinnings of derivative litigation. *Hawes* involved a shareholder action on behalf of a water company seeking to enjoin the corporation's supply of water at no cost to a city after the board refused a demand that the corporation commence the action. The Court reasoned that the city "conferred on the company valuable rights by special ordinance; namely, the use of the streets for laying its pipes, and the privilege of furnishing water to the whole population," that "[i]t may be the exercise of the highest wisdom to let the city use the water in the manner complained of," and that "[t]he directors are better able to act understandingly on this subject than a stockholder." 104 U.S. 450, 462 (1881).

[24] *Tooley*, 845 A.2d at 1033.

[25] White v. Panic, 783 A.2d 543, 550 (Del. 2001) (footnotes omitted); *see also Stone*, 911 A.2d at 366-67 ("[T]he right of a stockholder to prosecute a derivative suit is limited to situations where either the stockholder has demanded the directors pursue a corporate claim and the directors have wrongfully refused to do so, or where demand is excused because the directors are incapable of making an impartial decision regarding whether to institute such litigation").

This is entirely consistent with the law of England, where Delaware's renowned Court of Chancery finds its origins, which has recognized for more than 150 years that courts will not interfere in a company's internal management, and therefore a court should not countenance proceedings commenced without a company's permission.[26]

a. Wrongful Refusal of Demand

A board's decision to reject a shareholder demand for action (including commencement of litigation) will be respected so long as the presumptions of the business judgment rule are not rebutted and the board's decision to reject the demand -- for in this context, the underlying sought-to-be challenged board decision (to enter into a transaction, for example) is not the focus of inquiry -- can be attributed to any rational purpose. As explained by the Delaware Supreme Court in *Spiegel v. Buntrock*:

[26] *See* Foss v. Harbottle [1843] 2 Hare 461 (Ch.) ("It was not, nor could it successfully be, argued that it was a matter of course for any individual members of a corporation thus to assume to themselves the right of suing in the name of the corporation. In law the corporation and the aggregate members of the corporation are not the same thing for purposes like this; and the only question can be whether the facts alleged in this case justify a departure from the rule which, *prima facie*, would require that the corporation should sue in its own name and in its corporate character, or in the name of someone whom the law has appointed to be its representative."). Unlike Delaware, however, English law does not have a demand requirement but instead requires a shareholder to plead facts demonstrating that he falls within one of numerous exceptions before he may maintain a derivative action. Those exceptions include, among others, that (i) what has been done amounts to a "fraud on the minority" (generally deemed "equitable fraud," consisting of a benefit to the directors at the expense of the company) and the wrongdoers themselves are still in control of the company; (ii) the act complained of infringes a personal right of the shareholder seeking to bring the action; and (iii) the act complained of is illegal or *ultra vires*. *See Edwards v. Halliwell* [1950] 2 All E.R. 1064 (A.C.); *Clark v. Energia Global Int'l, Ltd.*, [2001] No. 173 (Berm. Sept. 18, 2002). Canada has adopted a different approach to derivative actions. *See* Business Corporations Act, S.C. 1974-75, c.33, ss. 239-40.

> The effect of a demand is to place control of the derivative litigation in the hands of the board of directors. Consequently, stockholders who . . . make a demand which is refused[] subject the board's decision to judicial review according to the traditional business judgment rule. . . . Absent an abuse of discretion, if the requirements of the traditional business judgment rule are met, the board of directors' decision not to pursue the derivative claim will be respected by the courts."[27]

Indeed, insofar as a shareholder demand represents a "tacit" concession that a majority of the board is independent and disinterested, the only issue to be determined by the court in assessing whether a demand has been wrongfully refused is the reasonableness of the board's investigation of the matter set forth in the demand and, specifically, whether the decision to reject demand can be attributed to any rational purpose.[28] It is unsurprising, therefore, that most shareholder challengers forgo making a demand altogether, arguing instead that a demand would have been "futile" insofar as the defendant directors allegedly lacked the requisite independence or disinterestedness to objectively consider a demand in the first instance.

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[27] 571 A.2d 767, 775-76, 777 (Del. 1990) (citation omitted). Indeed, "[i]f Courts would not respect the directors' decision not to file suit, then demand would be an empty formality." *Id*. at 777-78; *see also* In re Consumers Power Co. Derivative Litig., 132 F.R.D. 455, 465 (E.D. Mich. 1990) ("Whether to sue or not to sue is ordinarily a matter for the business judgment of directors, just as is the decision that the corporation will make bricks instead of bottles'") (citation omitted).

[28] *See* Scattered Corp. v. Chicago Stock Exch., Inc., 1996 WL 417507, at *3 (Del. Ch. July 12, 1996), *aff'd*, 701 A.2d 70 (Del. 1997); *see also* Baron v. Siff, 1997 WL 666973, at *2 (Del. Ch. Oct. 17, 1997) ("By making a pre-suit demand, a plaintiff concedes the independence and disinterestedness of the board. Thus, to establish wrongful refusal, a plaintiff must plead with particularity facts that create a reasonable doubt as to the good faith or reasonableness of a board's investigation. Mere conclusory allegations are insufficient.").

b. Demand Futility

In those instances where a plaintiff initiates a shareholder derivative action without first making a demand on the company's board, the complaint must allege with particularity the reasons justifying the plaintiff's failure to do so.[29] Where "a decision of the board of directors is being challenged in the derivative suit,"[30] a plaintiff alleging demand futility bears the burden of pleading particularized facts that, if true, would "raise a reasonable doubt as to (i) director disinterest or independence or (ii) whether the directors exercised proper business judgment in approving the challenged transaction."[31] In contrast, when "'determining demand futility in the absence of a business decision'" -- *e.g.*, an alleged failure of oversight by the board -- a court must "'determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.'"[32]

Particularly significant, and most unusual in the context of litigation in the United States, "[t]he 'heavy burden' of *pleading* demand futility is a *substantive* component of a plaintiff's case and, as such, the failure to meet [the above] showings . . . ends a court's inquiry before it can even address the merits of the challenged

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[29] *See* Ct. Ch. R. 23.1.

[30] Rales v. Blasband, 634 A.2d 927, 933 (Del. 1993).

[31] Grobow v. Perot, 539 A.2d 180, 186 (Del. 1988) (citing *Aronson*, 473 A.2d at 814).

[32] *Stone*, 911 A.2d at 367 (quoting *Rales*, 634 A.2d at 934).

transaction."[33] That said, depending on the precise facts as to the members of the Board, and in particular, a majority of the Board, the lack of independence/disinterestedness that may accompany merger transactions involving fiduciaries can satisfy this showing and subject the merits of director decisions approving such transactions to heightened judicial scrutiny.[34]

2. The Business Judgment Rule in the Context of Extraordinary Transactions

As noted above, one component of the business judgment rule is the duty of care, which requires directors to adequately inform themselves of material facts prior to making business decisions. In the words of Delaware Supreme Court in the seminal case of *Smith v. Van Gorkom*,[35] "[t]he determination of whether a business judgment is an informed one turns on whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'"[36] The standard of review for claims that directors breached their duty of care is "gross negligence"[37] but cases like *Van Gorkom* show that, as a practical matter, courts often have applied an ordinary negligence standard.[38]

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[33] *In re The Ltd.*, 2002 WL 537692, at *3 (citing *Aronson*, 473 A.2d at 814) (emphasis added).

[34] *See infra* Parts III & V.

[35] 488 A.2d 858 (Del. 1985).

[36] *Id.* at 872 (quoting *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del. Ch. 1971)).

[37] *Aronson*, 473 A.2d at 812 ("[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence").

[38] *See* Allen et al., *supra* note 11, at 1300 ("Suffice it to say that the alleged failures of process that supported the [*Van Gorkom*] court's holding may have amounted to ordinary

Van Gorkom involved a claim by a minority shareholder of Trans Union that the company's board had breached its duty of care by approving a merger in which the Trans Union shareholders would receive fifty-five dollars per share, representing a fifty percent premium over the company's then market price.[39] After the chairman of the board unilaterally devised a plan to sell the company and found a buyer, he called a board meeting in which he first informed the board of his plans.[40] At the conclusion of that board meeting, which lasted less than two hours and did not involve consultation with or presentations by the company's financial advisors, Trans Union's board, relying on oral presentations by the company's CEO and CFO concerning the company's intrinsic value, passed a resolution approving the transaction.[41] Notably, there was no issue concerning the independence and disinterestedness of Trans Union's board, nor was there any question as to the board's good faith belief that it was acting in the best interests of the corporation. The Delaware Supreme Court nevertheless held that the directors had breached their duties of care by failing to inform themselves and discuss adequately the intrinsic value of the company.[42] The directors were thus "found liable not for what they

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negligence, but its difficult to argue that they constituted gross negligence, which involves a devil-may-care attitude or indifference to duty amounting to recklessness").

[39] *Van Gorkom*, 488 A.2d at 863-64.

[40] *See id*. at 864-870.

[41] *See id*. at 868-69.

[42] *See id*. at 891.

decided but for how they decided it."[43] *Van Gorkom* accordingly stands for the proposition that board decisions made hastily and on a not-fully-informed basis -- even if made in good faith without direct self-interest, and substantively fair -- will not be accorded the protections of the business judgment rule.[44]

III. The "Entire Fairness" Standard of Review

As noted above, the deferential business judgment rule is displaced in favor of the "entire fairness" standard of review where a plaintiff succeeds in rebutting that rule's presumptions. Entire fairness will thus apply when a majority of the board has a disabling, personal financial interest in a transaction, or a conflicted director or shareholder "controls or dominates the board as a whole."[45] The entire fairness standard of review also governs self-dealing transactions involving controlling shareholders.[46]

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[43] Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 676 (2002).

[44] *Van Gorkom*, 488 A.2d at 872 ("Under the business judgment rule there is no protection for directors who have made 'an unintelligent or unadvised judgment'") (quoting Mitchell v. Highland-Western Glass, 167 A. 831, 833 (Del. Ch. 1933)); *see also* Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989) (explaining that analysis of a board's decision-making process examines "whether a board has acted in a deliberate and knowledgeable way in identifying and exploring alternatives").

[45] Telxon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002); *see also QVC*, 637 A.2d at 42 n.9 ("Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply even more exacting scrutiny to determine whether the transaction is entirely fair to the stockholders").

[46] A shareholder is a "controlling" one, with concomitant duties to the controlled entity, "if it owns a majority interest in or exercises control over the business affairs of the corporation." Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1113-14 (Del. 1994). It bears noting that "a significant stockholder that does not, as a general matter, exercise actual control over the investee's business and affairs or over the investee's board of directors but does, in fact, exercise actual control over the board of directors during the

Simply stated, entire fairness review aims to safeguard the interests of stockholders where conflicted directors and/or controlling shareholders have such skin in the game that a court concludes that they may be motivated by a desire to inequitably assert their influence.[47]

A. Fair Dealing and Fair Price

"According to the now familiar words of [the *Weinberger*] opinion, entire fairness has two aspects: fair dealing and fair price. This test, however, is not a 'bifurcated one between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.'"[48] Fair dealing "embraces

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course of a particular transaction, can assume fiduciary duties for purposes of that transaction." In re Western Nat'l Corp. S'holders Litig., 2000 WL 710192, at *20 (Del. Ch. May 22, 2000).

[47] As recognized by the Court of Chancery in the context of a "going private" merger transaction involving a controlling shareholder (which observation is equally applicable to transactions involving interested directors), entire fairness is "premised on a sincere concern that mergers with controlling stockholders involve an extraordinary potential for the exploitation by powerful insiders of their informational advantages and their voting clout." In re Cox Commc'ns Inc. S'holders Litig., 879 A.2d 604, 617 (Del. Ch. 2005). Delaware law nevertheless recognizes that interested director and controlling shareholder transactions can benefit shareholders financially, and does not outlaw or condemn them as such. *See* DEL. CODE ANN. tit. 8, § 144. Rather, "[t]he key to upholding an interested transaction is the approval of some neutral decision-making body." Williams v. Geier, 671 A.2d 1368, 1379 (Del. 1996); *see also* In re Tele-Communications, Inc. S'holders Litig., 2005 WL 3642727, at *8 (Del. Ch. Dec. 21, 2005) (hereinafter "*TCI*") ("Ratification of [an interested self dealing or controlling shareholder] transaction by disinterested directors or shareholders can have a powerful legal effect").

[48] Gesoff v. IIC Indus Inc., 902 A.2d 1130, 1144 (Del. Ch. 2006) (quoting *Weinberger v. UOP, Inc.*, 457 A.2d 701, 708 (Del. 1983)). There has been ongoing discussion (and litigation) concerning whether "fair price 'trumps' unfair process." *See, e.g.*, *Oliver v. Boston Univ.*, 2006 WL 1064169, at *25 (Del. Ch. April 14, 2006) (determining that a finding of fair price precluded damages where defendants had breached their duties of loyalty despite the fact that "there was no process to protect the interest of the minority shareholders"); *see also* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 798 n.41 (2003) ("Suppose the price is entirely

questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[49] Fair price "relates to the economic and financial considerations of the [challenged transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."[50]

"As defendants still carry the burden of demonstrating fair dealing, defendants must show the lack of any process flaws that would likely lead to an unfair result."[51] Moreover, "where the pricing terms of a transaction that is the product of an unfair process cannot be justified by reference to reliable markets or by comparison to substantial and dependable precedent transactions, the burden of persuading the court of the fairness of the terms will be exceptionally difficult."[52] The entire fairness test is therefore considered the most exacting standard of review utilized by Delaware courts and is often outcome determinative.[53]

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fair, but the process is faulty. To what else are shareholders entitled beyond a fair price?").

[49] *Weinberger*, 457 A.2d at 711.

[50] *Id*.

[51] *TCI*, 2005 WL 3642727, at *9.

[52] Valeant Pharm. Int'l v. Jerney, 921 A.2d 732, 748 (Del. Ch. 2007).

[53] *See, e.g.*, Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) ("'Because the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation'") (quoting Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1988)).

B. Shifting the Burden

Although the standard of review for conflicted director and controlling shareholder transactions remains entire fairness, defendants may shift the burden of proof to a challenging plaintiff by deferring to a properly empowered and functioning special committee of independent and disinterested directors created to safeguard the interests of all shareholders.[54] As addressed in detail below, however, defendants bear the initial burden of "establish[ing] that the special committee was truly independent, fully informed, and had the freedom to negotiate at arm's length."[55]

"[I]ndependence is the *sina qua non* of the entire negotiation process."[56] "'Although perfection is not possible,' unless the controlling or dominating shareholder [or interested board] can demonstrate that it has not only formed an independent committee but also replicated a process 'as though each of the contending parties had in

[54] *See, e.g.*, Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997) (holding that if defendants can satisfy this showing, the burden of demonstrating unfair dealing and unfair price will shift to the plaintiff). Interested directors and controlling shareholders can also shift the burden of proving entire fairness by submitting the challenged transaction to a properly structured shareholder vote – *i.e.*, one preceded by full disclosure and conditioned on approval by a majority of a company's minority stockholders. *See, e.g.*, Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985) ("approval of a merger . . . by an informed vote of a majority of the minority shareholders . . . shifts the burden of proving the unfairness of the merger entirely to the plaintiffs"); In re Pure Res., Inc. S'holders Litig., 808 A.2d 421, 442 (Del. Ch. 2002) (by including "a non-waivable majority of the minority vote condition . . . . the ability of the controlling stockholder to both offer and accept is taken away, and the sell-side decision-making authority is given to the minority stockholders"); In re PNB Holding Co. S'holder Litig., 2006 WL 2403999, at *15 (Del. Ch. Aug. 18, 2006) (holding in the shareholder ratification context that the underlying vote must be a majority of the total outstanding shares, not just a majority of the minority who voted).

[55] *TCI*, 2005 WL 3642727, at *8.

[56] *Gesoff*, 902 A.2d at 1146.

fact exerted its bargaining power at arm's length,' the burden of proving entire fairness will not shift."[57] Stated differently, conflicted fiduciaries "must do more than establish a perfunctory special committee of outside directors. Rather, the committee must function in a manner which indicates that the controlling shareholder [or interested board] did not dictate the terms of the transaction and that the committee exercised real bargaining power 'at an arm's length.'"[58]

"[A] well constituted special committee should be given a clear mandate setting out its powers and responsibilities in negotiating the interested transaction," which "mandate should include the power to fully evaluate the transaction at issue, and, ideally, include what th[e Delaware] court[s] ha[ve] called the 'critical power' to say 'no' to the transaction."[59] Also important is "the quality of the advice its members receive from

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[57] *Lynch*, 638 A.2d at 1121 (quoting *Weinberger*, 457 A.2d at 709-710 n.7).

[58] *Tremont*, 694 A.2d at 429 (citations omitted); *see also In re Trans World Airlines, Inc. S'holders Litig.*, 14 Del. J. Corp. L. 870, 880, 884 (Del. Ch. Oct. 21, 1988) (holding that a special committee appointed to represent minority shareholders in connection with a going private merger "did not supply an acceptable surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm's-length adversary" because the committee "did not adequately understand its function -- to aggressively seek to promote and protect minority interests").

[59] *Gesoff*, 902 A.2d at 1146; *see also id.* ("[T]he controller's commitment to leave the essential fate of the transaction in the hands of the special committee is a significant one, because it ensures that the merger offer is not negotiated in the shadow of punitive action by the controller if the minority resists the merger"). Indeed, a special committee given the narrow mandate of merely determining the fairness of a non-negotiable offer does not satisfy the requisite threshold for purposes of shifting the burden of entire fairness. *See* Rabkin v. Olin Corp., 1990 WL 47648, at *6 (Del. Ch. Apr. 17, 1990). This is so even assuming that a committee believes that the underlying transaction consideration is "fair," because a properly functioning committee must "strive to negotiate the highest or best available transaction for the shareholders," as opposed to one that simply falls "within a range of fairness." *Trans World Airlines*, 14 Del. J. Corp. L. at 884.

their legal and financial advisors" and whether the special committee "retain[ed] separate legal and financial advisors."[60]

Thus, while not technically required, proper deference by interested fiduciaries to independent and disinterested directors -- or shareholders -- will be accorded great significance by Delaware courts in considering interested self dealing transactions.

IV. *Unocal*'s Enhanced Reasonableness Review

A board's decision to adopt defensive measures in response to an unfriendly contest for corporate control is another example of a situation where the business judgment rule does not apply as the default standard of review for evaluating the conduct of directors. This exception is based upon the adversarial atmosphere of hostile takeovers and the inherent conflicts of interest attendant to defensive decisions made by directors facing alleged threats to control. By definition, target boards in this setting stand opposed to a suitor's desire to acquire their company. Accordingly, there exists the "omnipresent specter" that incumbent directors may be acting out of a concern to protect their own positions when responding to these threats. Before a board's defensive measures will be accorded the protections of the business judgment rule in the context of hostile takeovers, therefore, directors must first satisfy the two-step reasonableness test established by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co*.[61]

Referred to as "enhanced judicial scrutiny," the *Unocal* test requires that directors responding to hostile overtures for control demonstrate: first, that "they had

[60] *TCI*, 2005 WL 3642727, at *10.

[61] 493 A.2d 946 (Del. 1985).

reasonable grounds for believing that a danger to corporate policy and effectiveness existed,"[62] and second, that the "defensive measure [undertaken in response thereto was] reasonable in relation to the threat posed."[63] "The obvious requisite to determining the reasonableness of a defensive action is a clear identification of the nature of the threat.'"[64] With respect to *Unocal*'s second showing, a defensive measure will be found disproportionate if it is either draconian (*i.e.*, coercive or preclusive) or falls outside a range of reasonable responses.[65]

Notably, the Delaware Supreme Court has linked *Unocal*'s two part showing to both the business judgment rule and the entire fairness standard of review. Specifically, it has held that assuming that a board's actions are found to pass muster under *Unocal* as reasonable, its defensive actions should then be subjected to review under the highly deferential business judgment rule.[66] If, in contrast, directors are unable

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[62] *Id*. at 955. *Unocal* held that the directors could satisfy the reasonableness prong by making a showing of good faith and conducting a reasonable investigation. *See id*. It also noted numerous examples of coercive threats, including "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders . . . the risk of nonconsumation, and the quality of securities being offered in the exchange." *Id*.

[63] *Id*.

[64] *Unitrin*, 651 A.2d at 1384 (quoting Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1990)). The Delaware Supreme Court has articulated three generally accepted types of threats: (i) opportunity loss, (ii) structural coercion, and (iii) substantive coercion. *See id*. at 1384 (discussing and defining these threats).

[65] *Id*. at 1367.

[66] *See id*. at 1377 n.18 & 1390.

to satisfy enhanced scrutiny under *Unocal*, the defensive measures should be invalidated unless the directors can show that their actions were entirely fair.[67]

V. *Revlon* and the Duty to Maximize Shareholder Value

An offshoot of *Unocal* is the standard set forth by the Delaware Supreme Court in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[68] concerning the duties of target boards in the context of sales of corporate control. *Revlon* holds that if: (i) the directors initiate an active bidding process to sell the company; (ii) the directors abandon the company's long-term strategy and seek an alternative transaction involving the breakup of the company; *or* (iii) the directors engage in a plan or transaction that results in a "change in control" of the company, then they must run a fair process aimed at maximizing stockholder value by getting the best price, and they must ensure full disclosure to stockholders called upon to approve the sale of a company.[69] Directors in this context "must focus on one primary objective – to secure the transaction offering the best value reasonably available for the stockholders – and they must exercise their

[67] *See id*. The utility of coupling these standards has been criticized by three prominent current or former Delaware jurists. *See* Allen et al., *supra* note 11, at 1311 (opining that "once the target company board's defensive actions are found to satisfy or fail the *Unocal* test, any further judicial review of those actions under the business judgment or entire fairness standards is analytically and functionally unnecessary" and concluding that "[j]udicial review under *Unocal/Unitrin* should stand on its own, 'decoupled' from 'second step' review under those other two review standards").

[68] 506 A.2d 173 (Del. 1986).

[69] *See Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150-51 (Del. 1989); *see also Revlon*, 506 A.2d at 182 (holding that once it became certain that the corporation was for sale, "[t]he duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit"). Viewed under *Unocal*'s rubric, the board's failure to secure the best price reasonably available to all shareholders was violative of *Unocal* as a disproportionate response. *See id*.

fiduciary duties toward that end."[70] In other words, and as stated by the Court of Chancery in the recent and much publicized decision in *In re Netsmart Technologies, Inc. Shareholders Litigation*,[71] "[h]aving decided to sell the company for cash, the . . . board assumed the fiduciary duty to undertake reasonable efforts to secure the highest price realistically achievable given the market for the company."[72]

The rationale for this required undertaking is straightforward: where the sale of corporate control becomes inevitable, a corporation "no longer face[s] threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid."[73] "The whole question of defensive measures [thus becomes] moot" and "[t]he directors' role [is] changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[74] Put differently:

> Because of [an] intended sale of control, the [sale] transaction has economic consequences of considerable significance to the [target's] stockholders. Once control has shifted, the current [target] stockholders will have no leverage in the future to demand another control premium. As a result, the [target] stockholders are entitled to receive, and should receive, a control premium and/or protective devices of significant value. [Absent] protective provisions

[70] *QVC*, 637 A.2d at 44.

[71] 924 A.2d 171 (Del. Ch. 2007).

[72] *Id*. at 192. "Except for requiring the court to evaluate the reasonableness of the directors' action against the singular objective of current value maximization, the *Revlon* standard differs little from the *Unocal* standard in practical application." Allen et al., *supra* note 11, at 1321.

[73] *Revlon*, 506 A.2d at 182.

[74] *Id*.

> . . . the [target] directors ha[ve] an obligation to take the maximum advantage of the current opportunity to realize for the stockholders the best value reasonably available.[75]

The so-called *Revlon* duty "does not, of course, require every board to follow a judicially prescribed checklist of sales activities. Rather, the duty requires the board to act reasonably, by undertaking a logically sound process to get the best deal that is realistically attainable."[76] That said, a tension often arises concerning the steps a board can take to secure a favorable deal while at the same time not unduly foreclosing the potential for superior bids. Although a comprehensive discussion of the deal protection measures available to directors is beyond the scope of this paper, common measures including "lock ups,"[77] "no shops,"[78] "go-shops,"[79] "topping fees,"[80] and "termination

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[75] *QVC*, 637 A.2d at 43.

[76] *Netsmart*, 924 A.2d at 192; *see also QVC*, 637 A.2d at 44 ("In the sale of control context, the directors must focus on one primary objective – to secure the transaction offering the best value reasonably available for the stockholders – and they must exercise their fiduciary duties to further that end").

[77] "Lock-up" provisions typically grant a favored bidder an option to purchase a substantial block of the selling corporation's stock.

[78] "No shop" provisions generally involve undertakings by a selling corporation restricting it from shopping itself to other potential acquirers.

[79] "Go-shop" provisions permit selling corporations to actively solicit bids with other would be acquirers for specified periods of time following the execution of a merger agreement with an initial suitor. In contrast, a "window shop" provision allows the company to negotiate with suitors who appear and initiate bids after the deal is announced.

[80] A "topping fee" generally involves an agreement by the selling corporation to pay a potential merger partner a certain percentage of any amount ultimately received by the corporation's shareholders above the price provided for in a merger agreement, if the corporation does not enter into or consummate the transaction with that suitor and instead enters into a new agreement with a different acquiror.

fees"[81] have been upheld by the Delaware courts where reasonably designed to maximize shareholder value in the *Revlon* sale of control context.[82] Importantly, however, these same measures have been invalidated by Delaware courts when used to skew or manipulate the sales process.[83]

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[81] A "termination fee," often referred to as a "break-up" fee, is a fee to be paid to a friendly would-be acquirer should the proposed transaction not be consummated. Such fees both compensate a would-be acquirer for its expenses and increase the price of an acquisition to any other would be-acquirer.

[82] For example, in *In re J.P. Stevens & Co. S'holders Litig.*, 542 A.2d 770 (Del. Ch. 1988), the Court of Chancery refused to enjoin a Board-approved proposal that included "topping" and "termination" fees during an auction process, notwithstanding that another bidder had made overtures to negotiate a purchase of the company at a higher price. Recognizing that such measures "have the effect of tilting the playing field in favor of the holder of such rights," the Court nevertheless held that "that fact alone does not establish that they necessarily are not in the best interest of shareholders" inasmuch as a "board may tilt the playing field if, but only if, it is in the shareholders' interest to do so." *Id*. at 782. "Critical" to Court in finding that these deal protection measures were permissible was the absence of any bad faith on the part of the directors and the fact those fees benefited the company's shareholders by enabling the company to secure a value-maximizing deal.

[83] *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1989), illustrates this point. *Mills* involved an auction involving two bidders – Maxwell and KKR. After the Macmillan board accepted a slightly higher bid by KKR which was conditioned on, among other things, a "lock-up" option to purchase different Macmillan subsidiaries and a "no shop" provision, Maxwell indicated its continued willingness to top any KKR offer and also agreed to purchase the same subsidiaries governed by KKR lock-up for a higher price. But the Macmillan board refused to withdraw the KKR lock-up agreement and later was found to have "tipped" KKR to as to Maxwell's original bid in the first instance. The Delaware Supreme Court invalidated the lock-up because it effectively ended the auction despite Maxwell's repeated expressions of a willingness to further negotiate his offer. It also found that the no-shop was inappropriately agreed to by the board, reasoning that "[a]bsent a material advantage to stockholders from the terms or structure of a bid that is contingent on a no-shop, a successful bidder imposing such a condition must be prepared to survive a careful scrutiny which that concession demands." *Id*. at 1287. In determining that the auction did not pass muster under *Revlon*, the Court held that there had been an "illicit manipulation of the board's deliberative process by self-interested corporate fiduciaries" and that "this auction was clandestinely and impermissibly skewed in favor of KKR." *Id*. at 1279, 1281.

Thus, in stark contrast to the business judgment rule, "the *Revlon* standard contemplates a judicial examination of the reasonableness of the board's decision-making process."[84] Nevertheless, courts applying *Revlon* still "should be deciding whether the directors made a reasonable decision, not a perfect decision," and "[i]f a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination."[85]

VI. Recent Market Developments and Case Law

The recent wave of corporate merger transactions involving private equity deals highlights the conflict of interest concerns addressed above. Given the desire or need by many private equity suitors, as opposed to strategic buyers, to recruit existing managers to run targeted businesses and the reality that the most natural set of candidates is a target's existing management, the concern exists that senior management may favor a sale to a private equity firm (or other "financial buyer") without adequate regard for the interests of the other stockholders. Challenges to these transactions are thus assessed under *Revlon* as opposed to the deferential business judgment rule. That said, and as illustrated in a series of recent cases set forth below, the board's charge in this context remains the same as it has always been: independent and disinterested directors must employ a reasonable process that is reasonably designed to achieve the most valuable transaction for all stockholders.

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[84] *Netsmart*, 924 A.2d at 192 (citing *QVC*, 673 A.2d at 45).

[85] *QVC*, 637 A.2d at 45.

A. *In re SS&C Technologies, Inc., Shareholders Litigation*[86]

SS&C involved a proposed settlement of a class action concerning a challenge to a management-led buyout of SS&C Technologies Inc. ("SS&C") sponsored by a private equity firm, Carlyle Investment Management L.L.C. ("Carlyle"). Carlyle's proposal was solicited by SS&C's CEO, William C. Stone, "as part of an informal process to 'test the waters' regarding a sale of the company during which Stone and an investment banking group retained by him in his official capacity met with six private equity firms."[87] Stone disclosed his solicitation of financial buyers to the full SS&C board only after Carlyle submitted its initial proposal to acquire SS&C. In response, SS&C's board appointed a special committee, which, "after a brief effort to identify another buyer, . . . reached agreement with Carlyle at a price only slightly higher than Carlyle negotiated with Stone."[88]

The plaintiffs in *SS&C* did not move to enjoin the transaction, but instead concluded that certain disclosures in SS&C's preliminary proxy materials were materially misleading and incomplete. Plaintiffs thereafter sought to settle the action based upon unspecified additional disclosures to be included in supplemental SS&C proxy materials.[89] The Court disapproved the settlement because it was unable to conclude that

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[86] 911 A.2d 816 (Del. Ch. 2006).

[87] *Id*. at 818.

[88] *Id*. at 820.

[89] Under Delaware (and most States' and federal law), judicial review and approval is required before class or derivative actions may be settled. *See* DEL. CH. CT. R. 23(e) (governing class actions); DEL. CH. CT. R. 23.1(c) (governing derivative actions).

plaintiffs' counsel had adequately represented the interests of the class or that the settlement terms were fair and reasonable.

Significant for purposes of this paper was dicta in which the Court chastised the plaintiffs' attorneys for "fail[ing] to come to grips with the fact that Stone had an array of conflicting interests that made him an unreliable negotiator or that the special committee was placed in a difficult position by [his] preemptive activities."[90] Specifically, the Court was concerned that "a manager who has the opportunity to both take $72.6 million in cash from the transaction and roll a portion of his equity into a large equity position in the surviving entity has a different set of motivations than one who does not."[91] It also took issue with plaintiffs' attorneys' failure to adequately address "whether, given Stone's precommitment to a deal with Carlyle, the board of directors was ever in a position to objectively consider whether or not a sale of the enterprise should take place" and whether "Stone's general agreement to do a deal with Carlyle ma[de] it more difficult for the special committee to attract competing bids, especially from buyers not interested in having Stone own a significant equity interest in the surviving enterprise."[92]

B. *In re Netsmart Technologies, Inc. Shareholders Litigation*[93]

At issue in *Netsmart* was a going private merger between two private equity firms and Netsmart Technologies, Inc. ("Netsmart"), a micro-cap supplier of

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[90] *SS&C*, 911 A.2d at 820.

[91] *Id*.

[92] *Id*.

[93] 924 A.2d 171 (Del. Ch. 2007).

enterprise software to behavioral health and human service organizations. Responding favorably to "overtures" by private equity buyers, Netsmart's management "steered the board away from any active search for a strategic buyer" and successfully "encouraged the board to focus on a rapid auction process involving a discrete set of possible private equity buyers."[94] After adopting this strategy, the Netsmart board formed a special committee to represent the interests of Netsmart's disinterested stockholders.

The special committee, which "collaborate[d] closely with Netsmart's management, allowing the company's Chief Executive Officer to participate in its meetings and retaining [Netsmart's long-standing financial advisor] as its own,"[95] thereafter "sought to stimulate interest on the part of seven private equity buyers, and generated competitive bids from only four."[96] After the committee negotiated with and recommended approval of a deal with one of these four, which recommendation was approved by Netsmart's board, the company signed a merger agreement that included a "no shop" provision prohibiting Netsmart from actively shopping the company, as well as a 3% termination fee. "As in most private equity deals," the deal contemplated that "Netsmart's current executive team [would] continue . . . manag[ing] the company and . . . share in an option pool designed to encourage them to increase the value placed on the company in the Merger."[97]

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[94] *Id*. at 175.

[95] *Id*.

[96] *Id*.

[97] *Id*.

The Court in *Netsmart* was highly critical of the Netsmart board for having limited its search for potential buyers to private equity firms (and for having failed to contact prospective strategic buyers). Specifically, the Court rejected what it categorized as "decade-spanning, sporadic chats" with potential strategic buyers as defendants' proffered justification for a private equity sale; and the Court held that plaintiffs had "established that the Netsmart board likely did not have a reasonable basis for failing to undertake *any* exploration of interest by strategic buyers."[98] The Court concluded, instead, that "[t]he record evidence regarding the consideration of an active search for a strategic buyer [wa]s more indicative of an after-the-fact justification for a decision already made, than of a genuine and reasonably-informed evaluation of whether a targeted search might bear fruit."[99] The Court also took issue with the special committee having allowed management to "drive" the due diligence process with respect to other potential bidders, given management's participation in the proposed transaction.[100]

The *Netsmart* court also rejected the notion that a post-signing check in the market for other buyers, coupled with a "traditional" 3% break up fee if the board found an alternative buyer, automatically passed muster as a reasonable method for maximizing value for a small company like Netsmart without any significant following

[98] *Id*. at 177, 196 (emphasis in original).

[99] *Id*. at 199.

[100] *See id*. at 194. The Court emphasized that "[i]n easily imagined circumstances, this approach to due diligence could be highly problematic. If management had an incentive to favor a particular bidder (or type of bidder), it could use the due diligence process to its advantage, by using different body language and verbal emphasis with different bidders. 'She's fine' can mean different things depending on how it is said." *Id*.

by securities industry analysts, holding that "[t]he 'no single blueprint' mantra is not a one way principle" and "[t]he mere fact that a technique was used in different market circumstances by another board and approved by the court does not mean that it is reasonable in other circumstances that involve very different market dynamics."[101]

Notably, however, the Court in *Netsmart* did not enjoin the proposed transaction, despite its concerns as to whether the directors had run a fair process. Instead, it issued an injunction requiring corrective disclosures concerning its opinion (as well as issues as to the final projections relied upon by Netsmart's financial advisor in providing its fairness opinion of the deal) -- and it left hanging over the parties' heads the not insignificant threat of money damages and appraisal awards in post-transaction proceedings.[102] The Court reasoned that "[b]y issuing an injunction requiring additional disclosure, the court gives stockholders the choice to think for themselves on full information, thereby vindicating their rights as stockholders to make important voting and remedial decisions based on their own economic self-interest."[103] "The granting of a broader injunction" (such as one precluding the transaction), however, would "pose a risk that [the acquiror] might walk or materially lower its bid"[104] -- and leave the shareholders in worse shape.

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[101] *Id*. at 197.

[102] *See id*. at 209-10.

[103] *Id*. at 207.

[104] *Id*. at 209.

C. *In re Lear Corp. Shareholder Litigation*[105]

Lear involved a challenge to a proposed acquisition of the Lear Corporation ("Lear") by a private equity fund headed by Carl Icahn. Lear's long time CEO first informed Lear's board of the Icahn proposal following "weeks of discussions" between the two; and the Lear board responded by forming a special committee to consider a possible deal. However, the committee authorized Lear's CEO to personally negotiate terms with Icahn, notwithstanding his prior discussions with Icahn and that a going private transaction would enable the CEO to immediately cash in on his multi-million dollar retirement benefits (which were tied up in the company's stock) and join in any future equity growth experienced by the company as a participant in the buyout.

Negotiations resulted in a $36 per share price (a modest increase over Icahn's initial $35 per share offer), a "go-shop" clause which allowed Lear to pursue other bidders for 45 days after the transaction was signed, and a "fiduciary out" enabling Lear to accept a superior third-party bid. Icahn also contractually committed to vote his Lear stock in favor of any superior deal accepted by Lear's board as well, and received an approximately 3% termination fee and limited matching rights as to any competing bid.

In rejecting the argument that Lear's directors had acted unreasonably in accepting Icahn's initial bid without demanding a full pre-signing auction, the Court observed that "[n]o one had asked Lear to the dance other than Icahn . . . even though it was perfectly obvious that Lear was open to invitations,"[106] as a result of Lear having gotten rid of its poison pill years earlier. It also noted the presence of the go-shop

[105] 926 A.2d 94 (Del. Ch. 2007).

[106] *Id*. at 119.

provision which allowed Lear to pursue other bidders for 45 days after the transaction was signed, and a “fiduciary out” enabling Lear to accept a superior third-party bid after the go-shop period ended. In short, the Court found that “[t]he Lear board had sufficient evidence to conclude that it was better to accept [a premium offer] if a topping bid did not emerge than to risk having Lear’s stock price return to the level that existed before the market drew the conclusion that Lear would be sold because Icahn had bought such a substantial stake.”[107]

As in *Netsmart*, the Court in *Lear* fashioned “a very limited injunction” ordering additional disclosures concerning “the CEO’s overtures to the board concerning his retirement benefits” and the fact that “the CEO harbored material economic motivations that differed from their own that could have influenced his negotiating posture with Icahn.”[108] The Court reasoned that “the plaintiffs [we]re in no position to ask [the Court] to refuse the Lear electorate the chance to freely determine whether a guaranteed $36 per share right now is preferable to the risks of continued ownership of Lear stock.”[109]

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[107] *Id*. at 124. The Court reached this conclusion notwithstanding what it described as “an infelicitous decision” by the special committee in that case “to permit the CEO to negotiate the merger terms outside the presence of Special Committee supervision,” because “there [wa]s no evidence that that decision adversely affected the overall reasonableness of the board’s efforts to secure the highest possible value.” *Id.* at 97.

[108] *Id*. at 98.

[109] *Id*. at 123.

D. *In re Topps Co. Shareholders Litigation*[110]

The Court in *Topps* was confronted with a challenge to a proposed deal between The Topps Company, Inc. ("Topps") and private equity buyers led by former Disney CEO Michael Eisner. Eisner first expressed interest in a potential deal to Topps' CEO while Topps was being threatened with a proxy contest for control. Following a meeting between the two on the subject, Topps' CEO "directed Eisner to a long-time Topps independent director . . . to discuss any such transaction."[111] Discussions ensued after the settlement of the proxy contest and the formation of an "ad hoc committee" to explore and consider strategic alternatives for Topps.

After Eisner submitted a "formal indication of interest" to acquire Topps at a price of $9.24 per share (a 5.7% premium over Topps' then-current trading price), the Topps board met and ultimately rejected a strategy of embarking on a public sales process to auction Topps to the highest bidder.[112] Negotiations continued and Eisner increased his offer to $9.75 per share. Following more discussion, the parties executed a merger agreement that included a "go-shop" provision enabling Topps to continue to shop itself for 40 days.[113]

The Upper Deck Company ("Upper Deck"), Topps' chief competitor, tried to get into the bidding process after the deal was announced, but apparently was

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[110] 926 A.2d 58 (Del. Ch. 2007).

[111] *Id*. at 68-69.

[112] *Id*. at 70. Topps' board was "skeptical that a public auction would yield a more attractive offer" and concerned because "Eisner had indicated in no uncertain terms that he would withdraw his proposal . . . if Topps commenced an auction." *Id.*

[113] *See id*. at 71.

frustrated by the alleged lack of responsiveness by Topps to its diligence requests. Following the end of the go-shop period, Upper Deck made another offer to buy Topps for $10.75 per share -- $1 per share higher than Eisner's $9.75 price per share bid -- with a "promise to deal with manageable (indeed, mostly cosmetic) antitrust issues" that had been raised by Topps' directors.[114] But Topps' directors (i) "refused to treat Upper Deck as having presented a Superior Proposal, a prerequisite to putting the onus on Eisner to match that price or step aside," and (ii) went public with a disclosure concerning Upper Deck's bid "in a form that did not accurately represent [Upper Deck's] expression of interest and disparaged Upper Deck's seriousness."[115] Notably, a previously-executed "standstill" agreement with Topps prohibited Upper Deck from either publicly responding concerning its higher-priced bid or making that bid directly to Topps' stockholders by way of a tender offer.

The *Topps* court found "no unreasonable flaw in the approach that the Topps board took in negotiating the Merger Agreement with Eisner,"[116] including its decision to negotiate with Eisner privately and not conduct a full auction. Critical to this determination was the recognition by Topps' board "that they had not done a pre-signing market check" and their corresponding actions in "secur[ing] a 40-day Go Shop Period [with] the right to continue discussions with any bidder arising during that time who was deemed by the board likely to make a Superior Proposal."[117] The Court did, however,

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[114] *Id*. at 62.

[115] *Id*.

[116] *Id*. at 86.

[117] *Id*.

find that Topps' directors were likely to have breached their fiduciary duties in terminating their negotiations with a competing bidder (Upper Deck) after the go-shop had expired and by having failed to release Upper Deck from the prohibitions of the "standstill agreement" that prohibited Upper Deck from publicly responding about its high-priced bid or making a bid directly to Topps' stockholders by way of a tender offer.

Accordingly, the Court enjoined the merger vote unless and until Topps waived the standstill agreement to allow Upper Deck to comment on its negotiations with Topps and make an "all shares, non-coercive tender offer" to Topps' stockholders at a price higher than Eisner's bid. It also ordered supplemental disclosure concerning Eisner's assurances that he would retain Topps' existing management. *Topps* thus illustrates that courts will remove impediments constructed by management that prevent third parties from coming into or meaningfully participating in an auction process or making bids directly to stockholders which would top a previously approved proposal supported by management.

VII. Conclusion

Directors are afforded great latitude in managing and directing the business and affairs of corporations under Delaware law. That leeway is even present, albeit subject to heightened scrutiny, in conflict situations where the interests of directors are more likely to diverge from those of the stockholders and the presumptions of the venerable business judgment rule do not apply. The key to such situations remains reasonable process and the utilization of properly empowered and informed independent and disinterested directors. Thus, proper deference to such directors will, under the umbrella of entire fairness, suffice to shift the burden of proving the unfairness of a transaction to a challenging plaintiff. And a reasonable bidding process (be that through an auction or a meaningful post-signing market check) by independent and disinterested directors in the context of *Revlon* will force challengers to demonstrate that the challenged conduct actually had a negative effect on the bidding process and caused a lower (and unfair) bid price. Simply stated, the informed exercise of independent and disinterested director judgment -- *i.e.*, the pillars of the business judgment rule -- will continue to be respected by the courts so long as the actions taken by properly functioning boards (or committees thereof) in conflict situations were reasonably designed to safeguard the interests of all stockholders.