Target Directors' Fiduciary Duties: An Initial Reasonableness Burden

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The use of the unsolicited "tender offer" as a means of garnishing corporate control has become a frequent phenomenon on the American business scene. Corporate financiers, seeking to acquire a controlling interest in a company through a tender offer, can provide stockholders of that company with a substantial return on their investment, sometimes greatly exceeding the stock's current market price.

With the increase in the use of unsolicited tender offers, directors of companies faced with a takeover threat (target boards) have developed their own tactics in an effort to deter takeovers they believe are not in the best interests of their companies and stockholders. As a result, stockholders are often prevented from realizing a profit. Unfriendly bidders deterred from making tender offers, and shareholders denied the financial benefits, have challenged both the validity of these tactics and the authority of directors to adopt them. They assert that the intricacies of the tactics violate statutory

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1 Federal "tender offer" legislation fails to define the term. Courts have formulated their own definition. The court in SEC v. Carter Hawley Hale Stores, Inc., 760 F.2d 945 (9th Cir. 1985), found that the existence of a tender offer is determined by the following factors: (1) active and widespread solicitation of public shareholders for shares of an issuer; (2) solicitation made for a substantial percentage of the issuer's stock; (3) offer to purchase made at a premium over the prevailing market price; (4) terms of the offer are firm rather than negotiable; (5) offer contingent on the tender of a fixed maximum number to be purchased; (6) offer open only for a limited period of time; (7) offeree subjected to selling pressure; and (8) public announcements of a purchasing program concerning the target company precede or accompany rapid accumulation of a large amount of a target's securities. Id. at 950 (citing Wellman v. Dickinson, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979), aff'd on other grounds, 682 F.2d 355 (2d Cir. 1982), cert. denied, 460 U.S. 1069 (1983)). See also Edgar v. MITE Corp., 457 U.S. 624, 626 n.1 (1982); Hanson Trust PLC v. SCM Corp., 774 F.2d 47 (2d Cir. 1985) (Hanson I). For a more encompassing definition, see S-G Securities, Inc. v. Fuqua Inv. Co., 466 F. Supp. 1114, 1126-27 (D. Mass. 1978) (a publicly announced intention to acquire a substantial block of a company's stock with the purpose of obtaining control and the subsequent rapid acquisition of large blocks of the stock constitutes a tender offer).


3 See tactics used in cases cited at note 16 infra.
law and that the directors have breached their fiduciary duties.⁴

This note suggests an approach courts should adopt when examining a target board’s actions taken in response to a takeover threat. Part I addresses a board’s fiduciary relationship to its company and shareholders and discusses the business judgment rule. Part II recommends that courts, to ensure that a target board’s actions protect the interests of the company and its shareholders, should require the directors to show the overall reasonableness of their actions. Part III analyzes the factors courts should consider to determine reasonableness. By applying the proper review, courts can keep the market for corporate control functioning in a manner that allows beneficial takeovers to occur, while giving a board sufficient authority to prevent those that do not benefit the company and its shareholders.

I. Fiduciary Duties and the Business Judgment Rule

State corporation statutes⁵ give directors broad authority to make decisions pertaining to their corporation’s “business and affairs.”⁶ Despite this broad power, state statutes and courts impose fiduciary duties of care and loyalty on directors. The duty of care requires a board of directors to exercise the care that a reasonably prudent person in a similar position would use under similar circumstances.⁷ The duty of loyalty requires directors to act in the

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⁴ See cases cited at note 16 infra.
⁵ Prior to 1968, tender offers were unregulated at the federal level and only one state had such regulation. See E. Aranow & H. Einhorn, Tender Offers for Corporate Control 1-10 (1973). Congress amended sections 13 and 14 of the Securities Exchange Act of 1934 (1934 Act) with the Williams Act in 1968 and 1970. See 15 U.S.C. §§ 78m(d), (e), 78n(d)-(f) (1981 & Supp. 1986). The Williams Act is primarily a disclosure statute. See S. Rep. No. 550, 90th Cong., 1st Sess. (1967); H.R. Rep. No. 1711, 90th Cong., 2d Sess. (1968). See also Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (breach of fiduciary duty is a matter of state law); Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757 (2d Cir.), cert. denied, 464 U.S. 1018 (1983) (Williams Act does not create any substantive right to challenge the defensive actions of target directors). The Act makes it unlawful for a person to make a tender offer for 5% of certain 1934 Act companies unless at the time of the offer such person has filed a statement with the Securities and Exchange Commission disclosing the bidder’s purpose for the offer, source of funds, financial background and, if the bidder intends to acquire a controlling interest, any future plans for structural or operational changes in the company. The tender offeror must include the same information in solicitation materials sent to shareholders and the target board. 15 U.S.C. § 78m(d)(1), n(d)(1) (1981). The Williams Act also prohibits fraud in connection with a tender offer, gives shareholders specific withdrawal rights, and requires the bidder to purchase shares tendered during the first ten days on a pro-rata basis. 15 U.S.C. § 78n(d)(3), (6), (e) (1981).

⁶ See, e.g., Del. Code Ann. tit. 8, § 141(a) (1983) (“the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors”); N.Y. Bus. Corp. Law § 701 (McKinney 1963 & Supp. 1986) (“the business of a corporation shall be managed under the direction of its board of directors”).

best interest of the corporation and its stockholders, and not in their own self-interest.⁸

When reviewing a board’s ordinary business decision to determine whether the directors have breached their fiduciary duties, courts have traditionally applied the business judgment rule. The rule affords directors a presumption that they acted on an informed basis, in good faith, and in the honest belief that they took the action in the best interests of the corporation and its stockholders.⁹ The rule thus incorporates the fiduciary duties of care and loyalty. The majority of courts require a plaintiff seeking to establish a prima facie case for breach of fiduciary duty to rebut the presumption.¹⁰ If the plaintiff successfully rebuts one of the three elements, the directors generally must show that their decision was substantively fair to the company and shareholders.¹¹

Courts often indicate that in applying the business judgment rule they are deferring to the broad authority that state legislatures

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¹⁰ Courts have found that if a plaintiff demonstrates a breach of either the duty of due care or loyalty, it is sufficient to establish a prima facie case of breach of fiduciary duty. See Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 274-77 (2d Cir. 1986) (Hanson II) (the plaintiff rebutted presumption by showing that the directors did not adequately inform themselves); Van Gorkom, 488 A.2d 858, 872 (under the business judgment rule directors who have made an unintelligent or uninformed judgment are not protected) (citing Mitchell v. Highland-Western Glass, 19 Del. Ch. 326, 330, 167 A. 831, 833 (1933)). See also Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 265-67 (2d Cir. 1984) (plaintiff rebutted presumption by showing directors’ self-dealing).

¹¹ See Zapata Corp. v. Maldonado, 430 A.2d 779, 788 n.17 (Del. 1981) (where the plaintiff shows directors’ self-interest, the burden shifts to the directors to establish the “intrinsic fairness” of their decision). See also Hanson II, 781 F.2d 264, 278-79 (burden shifted to directors to show substantive fairness of their defensive action after plaintiff showed directors acted on an uninformed basis); Bellis v. Thal, 373 F. Supp. 120, 123 (E.D. Pa. 1974), aff’d, 510 F.2d 969 (3d Cir. 1975); Van Gorkom, 488 A.2d 858, 895 (Del. 1985) (where plaintiff showed directors failed to inform themselves, directors were liable for the difference between agreed merger price and intrinsic value of their company).
have afforded directors. Others contend that the rule encourages competent people to become directors without fear of personal liability for honest errors of judgment. Additionally, courts have suggested that they are not equipped to review the merits of complex business decisions, as opposed to the decisionmaking process, made by highly qualified persons.

Target boards have relied on their broad authority to implement tactics which deter unfriendly takeovers. Directors have asserted that in voting to pursue a particular defensive plan, they were making a decision no different than any other business decision. Accordingly, directors contend that courts should apply the business judgment rule to their decisions, regardless of whether made in the face of a takeover threat or in the ordinary course of their company's business affairs. On the other hand, shareholders and raiders point out that in the majority of situations, once an unfriendly bidder acquires a controlling interest, the raider replaces

12 See Zapata, 430 A.2d at 782.
15 The majority of states have amended either their corporation or blue sky provisions to regulate tender offers. State legislatures have attempted to protect local management through these provisions by overburdening unfriendly tender offerors. See, e.g., North Star Int'1 v. Arizona Corp. Comm'n, 720 F.2d 578 (9th Cir. 1983) (state commission makes a binding determination as to the fairness of a tender offer). Various tender offer provisions tend to give directors an unreasonable advantage to resist a takeover by giving them excess time and placing additional costs and delay on bidders. See generally Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161 (1981). Through careful scrutiny of state takeover statutes, courts have prevented state legislatures from disrupting the balance of neutrality between takeover parties in favor of target management. See Edgar v. MITE Corp., 457 U.S. 624 (1982) (Illinois Business Take-Over Act invalid under commerce clause); L.P. Acquisition Co. v. Tyson, 772 F.2d 201 (6th Cir. 1985) (Williams Act preempts provisions of Michigan Take-Over Offers Act); National City Lines, Inc. v. LLC Corp., 687 F.2d 1122 (8th Cir. 1982) (portions of Missouri Takeover Bid Disclosure Act invalid under supremacy and commerce clauses); Bendix Corp. v. Martin Marietta Corp., 547 F. Supp. 522 (D. Md. 1982) (Maryland Corporate Take-Over Law was a direct restraint on interstate commerce and also frustrated accomplishment of federal securities laws in violation of supremacy clause). See generally Sargent, Do the Second-Generation State Takeover Statutes Violate the Commerce Clause?, 8 CORP. L. REV. 3 (1985).
the target board.\textsuperscript{17} Raiders and shareholders thus assert that courts must carefully scrutinize the actions taken by a board of directors in response to a takeover threat, because the directors might act with self-interest to keep themselves in office by preventing a change in ownership.\textsuperscript{18}

Courts have accepted the directors' contentions and thus have applied the traditional fiduciary duty analysis to actions taken in response to a takeover threat. The majority of courts accordingly do not place an initial burden on a board of directors before they can enjoy the presumption of the business judgment rule.\textsuperscript{19} These courts require the plaintiff to first present evidence that the directors acted on an uninformed basis, in bad faith, or primarily or solely for the purpose of preventing a change in control to keep themselves in office.\textsuperscript{20} If the plaintiff meets this burden, courts then require the directors to present evidence concerning the decision's fairness.\textsuperscript{21}

The problem with using this traditional approach in the take-

\textsuperscript{17} See, e.g., Reibstein, \textit{After a Takeover: More Managers Run, or Are Pushed, Out the Door}, Wall St. J., Nov. 15, 1985, at 25, col. 3.

\textsuperscript{18} See Treco, Inc. v. Land of Lincoln Sav. & Loan, 749 F.2d 374, 376 (7th Cir. 1984); Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 260 (2d Cir. 1984); Enterra Corp. v. SGS Assoc., 600 F. Supp. 678, 687 (E.D. Pa. 1985).


\textsuperscript{20} See, e.g., \textit{Hanson II, 781 F.2d at 274}. \textit{See also} Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 702 (2d Cir. 1980) (fact that directors would remain in control if their defensive tactics were successful is not alone sufficient to shift the burden to the directors); Panter v. Marshall Field & Co., 646 F.2d 271, 297 (7th Cir.) (even though directors might have taken defensive action to remain in control, plaintiff failed to show it was the sole or primary purpose), \textit{cert. denied, 454 U.S. 1092} (1981); Johnson v. Trueblood, 629 F.2d 287, 293 (3d Cir.), \textit{vacated on other grounds, 629 F.2d 302} (1980), \textit{cert. denied, 450 U.S. 999} (1981). \textit{But see Note, Tender Offer Defensive Tactics and the Business Judgment Rule, 58 N.Y.U. L. Rev. 621, 656} (1983) (if the plaintiff shows a substantial likelihood that a raider will replace the target directors after acquiring control, the burden shifts to the directors to show their conduct was fair and reasonable).

\textsuperscript{21} If a plaintiff establishes a prima facie breach of the duty of due care, directors must show evidence to the contrary or demonstrate the substantive fairness of their actions. \textit{See Hanson II, 781 F.2d at 277-78} (court shifted burden to target board to justify the substantive fairness of a lock-up option after finding plaintiff made a prima facie case for breach of the duty of due care). Where a plaintiff establishes a prima facie breach of the duty of loyalty in the takeover context, courts have indicated that directors do not have to prove that their action was substantively fair. Rather, directors need only show that their action was entered into for a proper or legitimate corporate purpose. \textit{See} Treadway Cos. v. Care Corp., 638 F.2d 357, 382 & n.47 (2d Cir. 1980) (applying New Jersey law). Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264-67 (2d Cir. 1984) (applying New York law) affirmed this position after actually shifting the burden. \textit{But see Klaus v. Hi-Shear Corp., 528 F.2d 225, 233-34} (9th Cir. 1975) (under California law directors must show a compelling business purpose). In Delaware, it appears that in light of \textit{Unocal}, where directors must initially
over context is that the plaintiff must present evidence of the directors' subjective intent, an extremely difficult burden to overcome. In fact, most courts and commentators agree that plaintiffs in most takeover cases cannot negate the presumption of the business judgment rule. Consequently, courts often do not inquire into the reasonableness or substantive fairness of decisions designed to prevent a takeover. If courts do not require a board to show the reasonableness or substantive fairness of its actions, the company and its stockholders can suffer because the board might have prevented a beneficial takeover. Without such a showing, directors might act with a desire to perpetuate themselves in office under a pretext of benefiting their company and stockholders. This concern continues to grow in light of the number of decisions upholding the actions of a target board of directors.

II. An Initial Burden of Proof

Because a target board, using corporate funds, might act primarily to further its own interests rather than those of the corporation and its stockholders, courts should examine the target board's actions before conferring upon the directors the protections of the business judgment rule. By requiring a board of directors in all takeover situations to show that it responded reasonably to a reasonably perceived threat, courts can promote a marketplace where directors deter only takeovers that are not in the company's or stockholders' best interest.

The Delaware Supreme Court in Unocal Corp. v. Mesa Petroleum Co. and Moran v. Household International, Inc. recognized the need for placing an initial burden on a board of directors in situations involving the threat of a takeover. Although the decisions upheld show reasonableness, that if a plaintiff shows self-interest or bad faith, the burden will shift to the directors to show the substantive fairness of their action.

23 Commentators have criticized courts for applying the business judgment rule to directors' decisions to resist a takeover as not properly scrutinizing whether the directors satisfied their fiduciary duties. See id. at 597-600. For a critique of Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981), and Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980), see Note, The Misapplication of the Business Judgment Rule in Contests for Corporate Control, 76 NW. U.L. REV. 980, 987-96 (1982).
26 500 A.2d 1346 (Del. 1985).
the target boards' defensive tactics, both evidence the judiciary's increased concern over the sometimes drastic actions taken by directors to remove unwanted takeover threats.

In Unocal, Unocal Corporation (Unocal) used a selective self-tender offer in response to an unsolicited tender offer by Mesa Petroleum Company (Mesa).27 The Delaware court applied the business judgment rule to determine if the Unocal board had breached any fiduciary duties to Unocal and its stockholders by voting to use the selective self-tender offer as a defensive tactic.28 The court, however, modified the rule by placing an initial burden on the Unocal board before it could enjoy the presumption of the business judgment rule. The court required the Unocal board to show that it had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership29 and, to ensure balance, that the defensive action taken was reasonable in relation to the threat posed.30 The court explained that the initial burden on the Unocal board was necessary in the context of a contest for corporate control because the directors might attempt to keep themselves in office by deterring a change in control.31

The court determined that the Unocal board met its initial bur-

27 Mesa, owner of 13% of Unocal, made an unsolicited tender offer to the Unocal stockholders offering to buy 37% of Unocal stock for $54 per share. 493 A.2d at 949. Once it owned 51% of Unocal, Mesa planned to merge the companies, providing the remaining Unocal shareholders with highly subordinated debentures purportedly worth $54 each. Id. The Unocal board of directors voted to reject Mesa's offer as "inadequate and coercive." Id. The Unocal board decided to instead make a tender offer to its own shareholders for 49% of Unocal's stock in exchange for $72 worth of senior secured debt for each share tendered. Id. at 951. More importantly, the board excluded Mesa from its offer. Id. Mesa immediately filed suit claiming the Unocal board violated its fiduciary duties when it voted to pursue the selective self-tender offer in response to Mesa's front-end loaded, two-tier offer. Id. at 951-52.

28 Id. at 954 (directors may rely on the protection of the business judgment rule for decisions to defend against a takeover threat) (citing Pogostin v. Rice, 480 A.2d 619, 627 (Del. 1984)).

29 493 A.2d at 955. The court added that the directors "satisfy that burden by showing good faith and reasonable investigation." Id. (citing Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964)). The Delaware court's subsequent decision in Moran indicates that the perceived danger did not necessarily have to result from "another person's stock ownership." See notes 34-41 infra and accompanying text.

30 493 A.2d at 955.

31 Id. at 954. The court noted that directors' decisions made in the face of a pending takeover bid "should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment." Id. It added, however, that "[b]ecause of the omnipresent spector that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." Id. See also Bennett v. Propp, 187 A.2d 405, 409 (Del. 1962) ("The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult.").
den and thus could rely on the presumption of the business judgment rule. After shifting the burden back to Mesa, the court found that Mesa failed to show that the Unocal board did not act in the best interests of the company and its shareholders. Accordingly, the court concluded that the Unocal board did not breach either of its fiduciary duties.

In Moran, the Delaware Supreme Court extended the Unocal analysis to a situation in which a board took action even though no actual tender offer had been made. The board of Household International, Inc. (Household) voted to adopt a rights plan in response to fears that Household might be vulnerable to an unfriendly takeover. The board explained that it was concerned that a takeover might involve front-end loaded, two-tier tender offers and bust-up takeovers that would harm Household, its stockholders, and its employees.

Moran, a dissenting board member and Household stockholder, filed suit to invalidate the plan. After finding that the Household board had the statutory power to adopt the rights plan, the court concluded that the board did not breach any fiduciary duties. Relying primarily on the Unocal holding, the court permitted the board to assert the business judgment rule because the board met its initial burden. The court found that the directors had reasonable grounds for believing Household was vulnerable to bust-up takeovers and coercive acquisition techniques, and

32 493 A.2d at 958.
33 Id. at 958-59.
34 500 A.2d at 1349. For a description of the "rights plan," see notes 141-46 infra and accompanying text.
35 The board was concerned with the increased frequency of bust-up takeovers and front-end loaded, two-tier tender offers which could harm Household and its stockholders.
36 Id.
37 Before addressing the fiduciary duty issue, the court made four other findings. First, the court found that §§ 151 and 157 of Delaware General Corporate Law gave the board the power to implement the rights plan. Id. at 1351-53. Second, the court found §§ 151 and 157 constitutional. The court explained that a board acting pursuant to a state statute provides an insufficient nexus for it to find the necessary state action for a commerce clause challenge or supremacy clause violation in light of the Williams Act. Id. at 1353. Third, the court found that shareholder approval was not needed to implement the rights plan because it did not change Household's fundamental structure. Id. at 1354. Fourth, the court found that the rights plan did not restrict a shareholder's ability to conduct a proxy contest. Id. at 1355. For other decisions upholding the validity of various poison pill rights plans, see Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., Nos. 353 & 354 (Del. March 13, 1986), aff'g 501 A.2d 1239 (Del. Ch. 1985); Horwitz v. Southwest Forest Indus., 604 F. Supp. 1110 (D. Nev. 1985). See also Note, Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred, 97 HARV. L. REV. 1964 (1984). But see Dynamics Corp. v. CTS Corp., Nos. 85-1601, 86-1608 (7th Cir. June 9, 1986).
38 500 A.2d at 1357.
39 Id. at 1356-57.
that the rights plan was a reasonable defensive mechanism to protect the company.\textsuperscript{40} Moran failed to rebut the presumption of the business judgment rule, and thus the court concluded that the Household board did not breach its fiduciary duties.\textsuperscript{41}

Unless courts are willing to scrutinize more closely a plaintiff’s contentions of breach of fiduciary duty,\textsuperscript{42} courts should place an initial reasonableness burden on directors, as the Delaware Supreme Court has done, before conferring the protection of the business judgment rule. Such a requirement better assures that the directors’ true motive in adopting a defensive tactic was to protect their company and its shareholders. At the same time, courts should defer to directors’ expertise and broad authority to act on behalf of their company and its shareholders. Courts should also avoid substituting their judgment for that of the directors by only inquiring into whether the directors’ actions were reasonable under the circumstances.

\section*{III. Determining Reasonableness}

Before granting the protection of the business judgment rule in a takeover context, courts should require the directors to show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and, to ensure balance, that the defensive action taken was reasonable in relation to the threat posed.\textsuperscript{43} As a part of their overall reasonableness burden, directors should initially prove they made a reasonable investigation into both the existence of a danger and the need for, and effectiveness of, defensive action to remove the perceived danger.\textsuperscript{44} To demonstrate the danger to the corporation, a board may present evidence of the inadequacy of the bidder’s tender offer, the coercive nature of an unsolicited bid, or the potential adverse impact a takeover might have on a target’s employees, creditors, customers, and perhaps even the local community.\textsuperscript{45}

Finally, a board can show that a defensive tactic was reasonable

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  \item \textsuperscript{40} \textit{Id.} at 1357. The court suggested that the rights plan could prevent the coercive nature of bust-up takeovers and front-end loaded, two-tier tender offers by making an unwanted takeover more difficult. Although the court did not explain how the plan would make takeovers posing a danger more difficult, the plan apparently had this effect because it increased the cost of acquiring control of Household by several billion dollars.
  \item \textsuperscript{41} \textit{Id.}
  \item \textsuperscript{42} The Court of Appeals for the Second Circuit did carefully scrutinize a target board decision in \textit{Hanson II}, 781 F.2d 264 (2d Cir. 1986). The Second Circuit, applying the traditional fiduciary duty analysis, enjoined a lock-up option the target board granted to a white knight in response to an unsolicited tender offer.
  \item \textsuperscript{43} See 493 A.2d at 955.
  \item \textsuperscript{44} See notes 47-76 infra and accompanying text.
  \item \textsuperscript{45} See notes 77-131 infra and accompanying text.
\end{itemize}
in relation to the danger posed by showing that the action taken removed an existing danger or deterred a potential danger from occurring, and was no more extensive than necessary. By requiring the directors to meet this initial burden, courts can better assure that the board’s actions truly benefit the company and its stockholders.

A. Reasonable Investigation

To determine whether directors have met their initial reasonableness burden, courts should consider whether a board made a reasonable investigation into the existence and impact of a danger and into the possible need for, and effectiveness of, defensive action. Courts should not allow directors to simply assert that they relied on the analysis and recommendation of their legal counsel and investment bankers. Rather, courts should require the directors to show that they made an affirmative effort to understand the nature of the threat to the company as well as the details and effectiveness of any defensive action.

In Moran, the court indicated that the Household board had adequately informed itself of Household’s vulnerability to the dangers of bust-up takeovers and coercive acquisition tactics and the details and effectiveness of the rights plan. The court found that the board had conducted financial studies showing Household’s vulnerability, information that included a three-page summary of the rights plan and various articles on the current takeover environment. Additionally, before the directors approved the plan, they had extensive discussions with their legal counsel and investment bankers which reflected a full and candid evaluation and critique of the plan. These important facts influenced the court’s finding that the directors made a reasonable investigation.

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46 See notes 132-57 infra and accompanying text.
47 The Unocal court indicated that directors meet their reasonable grounds for believing a danger existed burden by showing “good faith and reasonable investigation.” See note 29 supra. The court added that such proof is materially enhanced where a board comprised of a majority of outside independent directors approves the action. See 493 A.2d at 955. But see Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 266 n.12 (2d Cir. 1984) (“We are not persuaded that a different test applies to ‘independent’ as opposed to ‘inside’ directors under the business judgment rule.”).
48 For a description of the rights plan, see notes 141-46 infra and accompanying text.
49 500 A.2d at 1356.
50 Id.
51 The court found that the directors acted on an informed basis because they received a “knowledgeable critique” of the plan and were not “grossly negligent.” Id. The court concluded that the directors reasonably believed Household was vulnerable to bust-up takeovers and coercive acquisition techniques and adopted a reasonable defensive measure. Id. at 1357.
In Hanson Trust PLC v. ML SCM Acquisition, Inc., the United States Court of Appeals for the Second Circuit also considered whether a target board had adequately informed itself before adopting a defensive tactic. Although the court did not place an initial burden on the target board, it rejected the argument that the directors had an absolute right to rely on financial and legal advisors.

In Hanson, Hanson Trust PLC (Hanson) made an unsolicited $60 cash tender offer to the common stockholders of SCM Corporation (SCM). In response, SCM’s counsel advised the board to secure an offer from a white knight. Nine outside directors on the SCM board unanimously approved a $70 merger agreement with Merrill Lynch, Pierce, Fenner & Smith, Inc., and its related entities (Merrill Lynch). Hanson responded by raising its offer to $72 cash per share for all of SCM’s common stock, conditioned on SCM not granting anyone a lock-up option to purchase corporate assets. The SCM and Merrill Lynch management immediately terminated the $70 agreement. Under a new merger agreement, Merrill Lynch, through a corporate shell called ML SCM Acquisition, Inc., would first make a $74 per share cash tender offer for eighty percent of SCM’s outstanding common shares. A second-step merger was to follow in which the remaining twenty percent of SCM shareholders were to receive debentures valued at $74 per share.

As consideration for the new agreement, the SCM directors granted Merrill Lynch an irrevocable asset option to purchase SCM’s two most profitable divisions, conditioned on a third party acquiring more than one-third of SCM’s common stock. In agree-

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52 781 F.2d 264 (2d Cir. 1986).
53 The court, citing Unocal, noted that although “in other jurisdictions, directors may not enjoy the same presumptions per the business judgment rule, at least in a takeover context, . . . under New York law, the initial burden of proving directors’ breach of fiduciary duty rests with the plaintiff.” Id. at 273.
54 Id. at 275.
55 Id. at 268.
56 Id. at 269. A target board faced with a hostile takeover bid might attempt to find another bidder it prefers, commonly referred to as a white knight, to negotiate with on friendly terms.
57 Id. at 270. SCM and Merrill Lynch agreed that Merrill Lynch, through a corporate shell, ML SCM Acquisition, Inc., would make a $70 cash tender offer for approximately 85% of SCM’s common stock. A second-step merger would follow in which the remaining shareholders would receive $59.50 per share in cash and $10.50 in new debentures. Id. at 269.
58 Id. at 270.
59 Id.
60 Id.
61 Id.
62 Merrill Lynch made it clear that it would not proceed without the asset option. Id.
According to the asset lock-up option, the SCM board relied on the company's financial advisor's statements that the $74 offer was the best available and that the option price was fair to SCM stockholders. The board also relied on counsel's opinion that the decision to approve the agreement was within the discretion of the board's business judgment.

Hanson, concerned that SCM would be a financially unattractive company without the two major divisions, brought an action to restrain Merrill Lynch from exercising its asset lock-up option. The Court of Appeals for the Second Circuit, applying New York law, granted the preliminary injunction. The SCM board argued that it made an informed decision because it relied on the advice of legal and financial advisors that the options were "within the range of fair value." The Second Circuit rejected this argument. The court recognized that "while directors are protected to the extent that their actions evidence their business judgment, such protection assumes that courts must not reflexively decline to consider the

Under the proposed agreement, Merrill Lynch had the irrevocable right to purchase SCM's pigments business for $350 million and Durkee Famous Foods for $80 million. The principle advantage of a lock-up option is that it can induce an otherwise reluctant bidder to enter a bidding contest as a white knight and thus ultimately benefit target shareholders. An option might enhance a white knight's chance of success by making a company financially unattractive and deterring unfriendly bidders. The option also serves as insurance against failure because if a raider should prevail, a white knight can exercise a generally favorable option. See Note, Lock-up Options: Toward a State Law Standard, 96 HARV. L. REV. 1068, 1078 (1983). Lock-up options are not per se illegal, but are permissible if the option is reasonably structured to draw another bidder into the contest, and impermissible if it is calculated primarily to exclude hostile parties from the auction. See 781 F.2d at 274. But see Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981) (lock-up options constitute "manipulation" within anti-fraud provision of Williams Act). To determine whether a particular lock-up option is beneficial to shareholders and thus should be upheld, one commentator has proposed a list of factors: (1) the extent of the bidding advantage conferred by the option; (2) whether a conscientious negotiator could have, at the time the deal was made, reasonably construed the arrangement as beneficial to the target company and its shareholders; (3) the extent to which a white knight's offer is an improvement over the terms of a raider's offer; (4) whether the target board held out for the best deal it could get for shareholders, or merely accepted the terms offered by a white knight; and (5) the scope of the target board's efforts to locate another white knight willing to accept terms more favorable to the target company. See Note, supra, at 1078-81.

The investment banking firm, Goldman Sachs & Co., advised the SCM board that "the $74 offer was the best available, and was fair to SCM shareholders." 781 F.2d at 271. In a later letter, Goldman Sachs & Co. confirmed that the option prices were "within the range of fair value," and that the Merrill Lynch offer was "worth $1.25 to $1.50 more per share [to SCM shareholders] than the Hanson $72 cash [tender] offer . . . ." Id. at 272. In response to Merrill Lynch's $74 tender offer, Hanson terminated its $72 offer and increased its SCM holdings to 37%. Id. at 271-72. This triggered Merrill Lynch's right to exercise the option. Id. at 272. Hanson then filed suit and announced a $75 cash offer conditioned on judicial invalidation or withdrawal of the option right. Id. Merrill Lynch immediately announced it was exercising the option. Id. at 283.
content of their ‘judgment’ and the extent of the information on which it is based.”67 Thus, the court concluded that the plaintiff rebutted the presumption of the business judgment rule.68

The court correctly stated that directors must make their decision “on the basis of ‘reasonable diligence’ in gathering and considering material information.”69 The court added that a board has “some oversight obligations to become reasonably familiar with an opinion, report, or other source of advice before becoming entitled to rely on it.”70 Because the directors did not use reasonable diligence to inform themselves of the contents of the reports, the court found that they were not entitled to rely on them to meet their duty of due care.71 The court concluded that the directors failed to present legally sufficient evidence to the contrary72 or to justify the fairness of the option.73

Unfortunately, other courts have suggested that directors may simply rely on the advice of their financial and legal advisors without inquiring into the details or basis of the advice and its impact on the company and shareholders. In Horwitz v. Southwest Forest Industries,74 advisors informed the board of Southwest Forest Industries (SFI) that a stock purchase rights plan was in the company and stockholders’ best interests because it would deter unfair and inad-

67 Id. at 275.
68 Id. at 277.
69 Id. at 274.
70 Id. at 275.
71 The court did not apply the gross negligence standard for the duty of due care enunciated in Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985). But the court still found that “the SCM directors failed to take many of the affirmative directorial steps that underlie [a] finding of due care . . . .” 781 F.2d at 275. The court noted that the board did not even obtain a written opinion from its investment banker as to the value of the two businesses which were the subject of the option. Id. Moreover, the board never asked what the top value was, or why the two businesses generating half of SCM’s income were being sold for one-third of SCM’s total purchase price. Id. Thus, the court concluded that “the SCM directors’ paucity of information and their swiftness of decision-making strongly suggest a breach of the duty of due care.” Id. The court found that the directors did not become reasonably familiar with Goldman Sachs’s conclusion that the prices of the options were fair. Id. at 276. The court explained that if the directors had inquired about the “range of fair value,” Goldman Sachs would have told them that it did not investigate the range of fair value. Id. Thus, the court concluded that the “directors might have then discovered that the [option] prices represented lower valuations than their own experienced business judgment would allow them to approve.” Id.
72 The court reached its finding even though it did not find any evidence that the directors acted with self-interest or fraud. Id. at 276-77.
73 In applying price earnings ratios and using SCM’s own valuation charts, the court found that the actual value of the pigments division was between $420 and $544 million. Id. at 279. Regarding the Durkee Famous Foods business, the court also found evidence that it was optioned at a price significantly below its fair value. Id. at 280. The court also rejected the SCM directors’ arguments that the purpose of the option was to achieve a better bid for shareholders and that the option facilitated competition in the market for control of SCM. See id. at 281-83.
equate unsolicited tender offers.\textsuperscript{75} The court stated that the directors had a right to rely on the advice of investment bankers and legal counsel.\textsuperscript{76} The court did not condition this right on the directors making a reasonable investigation.

Often legal counsel and investment bankers are an asset to a board of directors faced with a possible danger to the corporation and stockholders. On the other hand, a tender offer may provide shareholders with an opportunity to enjoy a profit. Thus, courts must require directors to show that they made a reasonable investigation into the circumstances surrounding a possible takeover threat. The directors can meet this requirement by analyzing advisors' opinions and recommendations to understand the basis for the conclusion that a genuine danger exists, the need for and details of any proposed action, and the likelihood that the action, if taken, will remove the danger.

B. Dangers Posed to Target Companies

After requiring directors to show that they made a reasonable investigation, courts should, as part of directors' initial reasonableness burden, require the directors to present evidence of the perceived danger. These concerns most often involve inadequacy of price, coercive acquisition techniques, and employee welfare.

1. Inadequacy of Price

Courts generally allow directors to determine whether a tender offer is inadequate, and if appropriate, to take action to protect the company and shareholders. Although such deference is proper, courts must require the directors to show that the perceived danger was genuine by presenting evidence which establishes a reasonable basis for the directors' conclusion that the offer was inadequate.

The Unocal court, in addressing the directors' burden of show-
ing reasonable grounds for perceiving a danger, recognized that such danger may include inadequacy of the price offered.\textsuperscript{77} Unocal's investment bankers concluded that Mesa's offer was wholly inadequate, as well as coercive.\textsuperscript{78} The financial analysts based their determination on the minimum cash value per share that Unocal could expect from a sale or liquidation, concluding that this liquidation value exceeded Mesa's offer.\textsuperscript{79}

In Unocal, though Mesa's offer was inadequate, Mesa did not have express plans to sell Unocal after acquiring control. When a raider clearly expresses an intent to bust up a target company, the danger and unfairness to shareholders becomes even more readily apparent. In bust-up takeovers, the raider offers shareholders more than the stock's current trading price but below the company's per share break-up or liquidation value.\textsuperscript{80} By selling major divisions to pay their acquisition indebtedness, raiders are able to obtain the remaining divisions at virtually no cost. The gain to the raider's shareholders is to the target shareholders' detriment. The target board might as well sell the company in pieces, distributing the proceeds to shareholders. Thus, a raider's initial offer, which exceeded the stock's market price, is actually inadequate.

Recent cases illustrate the unfairness to shareholders. In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,\textsuperscript{81} Pantry Pride, an unfriendly bidder, planned to acquire Revlon by using junk bonds and eventually breaking up Revlon.\textsuperscript{82} The Delaware Supreme Court gave considerable weight to evidence demonstrating that if the Revlon board sold the company's divisions separately, the board could expect more per share than that offered by Pantry Pride, an affiliate of MacAndrews & Forbes.\textsuperscript{83}

\textsuperscript{77} Unocal, 493 A.2d at 955.
\textsuperscript{78} Id. at 950-51.
\textsuperscript{79} Unocal's investment bankers, Goldman Sachs & Co. and Dillon Reed & Co., expressed their opinion that the minimum cash value that Unocal shareholders could expect from a sale or orderly liquidation of Unocal, for 100% of its stock, exceeded $60 per share. Id. at 950. Mesa only offered $54 per share. Id. at 949.
\textsuperscript{80} See GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1018 (S.D.N.Y. 1985) (a bust-up takeover refers to a tender offeror's attempt to finance its acquisition by using the target's own assets and borrowing capacity); Moran, 500 A.2d at 1349 n.4.
\textsuperscript{81} Nos. 353 & 354 (Del. March 13, 1986), aff'g 501 A.2d 1239 (Del. Ch. 1985).
\textsuperscript{82} Revlon's investment banker told the board that Pantry Pride would finance its tender offer with junk-bonds and then would sell Revlon's business divisions separately to pay the indebtedness while still realizing a profit. Revlon, slip op. at 5. The investment banker informed the board that Pantry Pride's $45 offer was grossly inadequate. The investment banker reasoned that according to their analysis, if Revlon's business divisions were sold separately, and at the proper time, the shareholders could realize between $60 and $70 per share. Id. at 4-5.
\textsuperscript{83} The court noted that when the Revlon board concluded that Pantry Pride's tender offer was "grossly inadequate," they implemented defensive measures "in good faith, and on an informed basis, with reasonable grounds to believe that there existed a harmful
In *GAF Corp. v. Union Carbide Corp.*, the unfriendly bidder, GAF Corporation (GAF), made clear its intentions to bust up large segments of Union Carbide Corporation (Union Carbide) to pay its acquisition costs after acquiring control. The Union Carbide board concluded that a proposed tender offer and accompanying liquidation plan by GAF was "grossly inadequate and unfair and not in the best interests of the Company and its shareholders." The board reached its conclusion after its investment banker presented a valuation analysis containing the range of values that Union Carbide shareholders might realize if Union Carbide were liquidated. Because the values per share were greater than GAF’s offer, GAF would have acquired Union Carbide’s valuable gas, chemicals, and plastics businesses at virtually no cost.

To remove the danger of the inadequate offer, the Union Carbide board pursued a self-tender exchange offer and amended the company’s pension plan. The Union Carbide board argued that its self-tender exchange offer was designed to ensure that profits from its business operations would flow through to the shareholders of Union Carbide, rather than to the shareholders of GAF. The district court upheld these tactics, explaining that deterring an inadequate offer is entirely legitimate. A hostile tender offer, the court stated, is not entitled to have a target board smooth the path to control. Instead, the bidder must establish the ade-
The Delaware Supreme Court in Moran added an important dimension to inadequacy analysis. In Moran, the court considered the mere frequency of bust-up takeovers and front-end loaded, two-tier tender offers in Household's industry to show that a danger existed. The court accepted the Household board's contention that the availability and increased use of these takeover tactics posed a genuine danger to shareholders.

In Moran, financial studies showed that Household's stock was significantly undervalued in relation to the company's potential break-up value. This made Household vulnerable to a bust-up takeover. The Household board implemented a rights plan in a good faith belief that such a plan was necessary to protect Household shareholders. The court concluded that a board can establish a danger existed by showing that the company is vulnerable to takeover techniques designed to give raiders a windfall to the detriment of shareholders.

Courts should permit directors to assert that a tender offer was inadequate to show that a genuine danger to the company and shareholders existed. Some courts have allowed such an assertion without much of an evidentiary basis. Courts should, however, require directors to present evidence establishing some verifiable financial analysis as a basis for their conclusion, especially where there is no offer, as in Moran, to compare to the company's break-up value. In such cases, courts should require target directors to show some certainty of the danger and the connection to the target company. Moreover, as the Moran court recognized, where a board takes pre-takeover action in response to the possibility of a future inadequate offer, the action does not change the board's duty to evaluate an offer made at a later time.

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93 Id. at 1020.
94 See notes 26, 34-41 supra and accompanying text.
95 500 A.2d at 1349, 1357.
96 Id. at 1348-49.
97 Id. at 1357.
98 See Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981). In Panter, the board of Marshall Field & Co. issued a press release stating that Panter's $36 tender offer was inadequate. The court held that no reasonable juror could find that the press release was "deceptive" within § 14(e) of the Williams Act. Id. at 290. The Seventh Circuit considered evidence that the board merely believed it could obtain a higher price and that a foreign company might, at any time, make a $60 offer. Id. See also Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980) (suggesting that a tender offer may be inadequate when the tender offer is only within several dollars of the target stock's market price).
99 See notes 139-57 infra and accompanying text.
2. Coercive Acquisition Techniques

Coercive acquisition techniques such as front-end loaded, two-tier tender offers disrupt the marketplace by favoring bidders and pose a genuine danger to a target company and its stockholders. Thus, courts should allow directors to assert the use of such a takeover tactic to meet the danger requirement of their initial reasonableness burden.

In Unocal, Mesa's offer took the form of a front-end loaded, two-tier tender offer, where Mesa in the first tier offered to buy thirty-seven percent of Unocal's stock for $54 cash. With fifty-one percent control, Mesa planned to merge with Unocal in the back end, issuing highly subordinated debt securities to the remaining forty-nine percent of Unocal shareholders in exchange for their shares. The full Unocal Board voted to reject Mesa's offer, not only because it was inadequate in price, but because it was coercive in nature.

Front-end loaded, two-tier tender offers coerce shareholders into tendering in the first tier offer to avoid receiving securities in the second tier, back-end merger worth less than the consideration offered in the first tier. This creates a danger to target shareholders because it coerces them to tender in the first tier regardless of the adequacy of the offer.

The Unocal court acknowledged this danger, explaining that "[i]t is now well recognized that such offers are a classic coercive measure designed to stampede shareholders into tendering at the

100 A front-end loaded, two-tier tender offer is a two-step acquisition technique where in the first-step, front-end offer, the raider usually offers cash. In the second-step, back-end merger, the remaining target shareholders receive securities of the bidder valued below the consideration offered in the first-step tender offer. Thus, the acquisition is front-end loaded. In many cases the front-end offer is also inadequate. The merger is certain to occur because the bidder will vote its controlling shares. See Unocal, 493 A.2d at 956; Mirvis, Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues, 38 BUS. LAW. 485 (1983); Note, Front-End Loaded Tender Offers: The Application of Federal and State Law to an Innovative Corporate Acquisition Technique, 131 U. PA. L. REV. 389 (1982).

101 Unocal, 493 A.2d at 949.

102 Id. As evidence that the back-end securities were not worth $54 per share, the Delaware court noted that the District Court for the Central District of California entered an order requiring Mesa to issue a supplemental proxy statement to Unocal shareholders. Id. The statement had to disclose that the securities it planned to offer in the back-end merger of its two-tier tender offer were highly subordinated and that Unocal's capitalization would differ significantly from its then present structure. Id. at 949-50.

103 Id. at 950, 953. Unocal's investment banker provided an opinion stating that Unocal's per share liquidation value exceeded $60 compared to Mesa's purported $54 per share offer. Id. at 950.

first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction.” The court also found that the Unocal board feared for the interests of shareholders in the back-end merger who were to receive inadequate consideration in the form of highly subordinated debt securities. 

Takeover techniques such as front-end loaded, two-tier tender offers coerce shareholders to tender without making an informed decision. Board action is necessary to protect the interests of shareholders. Courts should allow directors to fulfill the danger element of their initial reasonableness burden by presenting evidence that a bidder employed a tactic designed to coerce shareholders to tender when it is not in their best interest.

3. Protection of Employee Welfare

In addition to protecting the company and its stockholders, directors might institute defensive tactics to protect the welfare of the target company’s employees, creditors, suppliers, and possibly even local communities. A reasonably perceived danger to these parties should serve as a basis for the danger element of the directors initial reasonableness burden.

The court in Union Carbide gave considerable weight to the directors’ concerns for employees in finding that the Union Carbide board did not breach its fiduciary duties by taking action in response to GAF’s unsolicited tender offer. GAF had expressed its intention to sell parts of Union Carbide after gaining control. In addition to pursuing a self-tender offer, the Union Carbide board voted to amend the company’s retirement plan. The amendment vested certain funds in participating employees in the event that a change in control occurred. The board intended to prevent the

106 493 A.2d at 956-57. The court noted the selective self-tender offer was reasonable and consistent with the board’s duty to ensure that the back-end minority shareholders received value equal to that given to the shareholders in the front end.
107 The Delaware Supreme Court in Unocal stated that “such concerns may include . . . the impact on ‘constituencies’ other than shareholders [that is] creditors, customers, employees, and perhaps even the community generally . . . .” Id. at 955. See generally Brecher, Lazarus & Gray, The Function of Employee Retirement Plans as an Impediment to Takeovers, 38 Bus. Law. 503 (1983). In light of the Delaware Supreme Court’s decision in Revlon, however, when a bidder poses an unavoidable danger a board cannot allow employee concerns to influence their decision to pursue action. See note 159 infra.
108 See notes 84-93 supra and accompanying text.
110 Id. at 1022, 1024-25.
111 The term “pension parachute” refers to the Union Carbide board’s amendment to the company’s retirement plan that permitted it to vest, for the benefit of participating and retired employees, corporate funds that were technically “in excess,” in the event of an unfriendly change in control. Id.
new owners from using the funds to finance their takeover to the
detriment of employees. The district court stressed that courts should not ignore the
welfare of loyal employees. The court noted that directors "might wish to assure fair and equitable recognition and treatment
for its relationships with pensioners, employees and manage-
ment" and that "[t]hese legitimate concerns . . . need not be left
to the goodwill of an unfriendly acquirer of corporate control."
The court determined that the Union Carbide board acted "within
the wide latitude of management authority conferred on a Board of
Directors by New York law and may be considered under the Business
Judgment Rule."
The United States District Court for the Eastern District of
Pennsylvania in *Enterra Corp. v. SGS Associates* also looked to em-
happy to uphold the validity of a standstill agree-
ment. The court went so far as to suggest that it would accept
the contention that such a defensive tactic might stabilize relations
with "various suppliers, customers, and lenders" in addition to pro-
moting the "retention (and recruitment) of key employees."
Courts must make certain that board action purportedly taken

112 *Id.* at 1022.
113 *Id.* at 1019.
114 *Id.* at 1018-19.
115 *Id.* at 1020. The court observed that employees, pensioners, and loyal members of
management are regularly accorded protection and security when a business is moved or
substantially liquidated. *Id.* at 1019. The court noted that such persons are similarly af-
fected by unfriendly raids on control of a company. *Id.*
116 *Id.* at 1018. The court accepted as reasonable the board's contention that it wanted
to assure fair and equitable treatment to its pensioners, employees, and management. *Id.* at
1018-20, 1035.
118 SGS Associates (SGS) held a substantial percentage of the outstanding shares of En-
terra (Enterra). *Id.* at 682. The Enterra board, as a defense tactic, reached a stand-
still agreement with SGS. This standstill agreement provided that SGS could not acquire
more than 15% of Enterra's outstanding shares and could not make a tender offer to En-
terra shareholders. *Id.* The agreement thus prevented SGS from attempting to acquire
control of Enterra. SGS subsequently attempted to acquire all the outstanding Enterra
shares, subject to board approval. *Id.* at 682-83. The Enterra board, relying on the advice
of its investment bankers, concluded that SGS' tender offer was financially inadequate and
refused to amend the agreement. *Id.* at 683, 690. The court found that the board did not
breach its fiduciary duties when it entered into the agreement and later rejected SGS' pro-
posal for modification of the standstill agreement. *Id.* at 689.
119 *Id.* The court noted that "[a]lthough, as with all actions taken by a board of direc-
tors, retention of control arguably was a motive for entering into the [standstill] Agree-
ment, it is clear that the primary purpose of the [b]oard . . . was to 'create a stable, certain,
and cooperative relationship between management [and] a substantial shareholder.'" *Id.*

Thus, the court determined that the board's decision refusing to modify the standstill
agreement in an effort to protect shareholders from an inadequate offer was within the
board's business judgment. *Id.*
for employee welfare is not a disguised attempt to keep the directors in office. In *Norlin Corp. v. Rooney, Pace Inc.*, the Court of Appeals for the Second Circuit found that the Norlin board's purpose in creating an employee stock option plan and trust (ESOP) was "not to benefit the employees but rather to solidify management's control of the company." Thus, the court concluded that the board failed to meet its fiduciary duty of loyalty.

In the case, the Norlin board transferred newly issued stock into the ESOP, but retained beneficial ownership and thus voting rights of the shares. This increased the board's holdings to forty-nine percent of the company's outstanding stock, which served to deter raiders. Affirming the district court's injunction preventing the board from voting the newly issued stock, the court explained that the timing of the ESOP's creation, the identity of the trustees, and the voting control of the ESOP shares indicated that "the ESOP was created solely as a tool of management self-perpetuation" and not to protect employees from a genuine danger.

Similarly, in *Minstar Acquiring Corp. v. AMF Inc.*, the United States District Court for the Southern District of New York issued a preliminary injunction preventing the AMF board from granting favorable stock options to employees. The board of AMF, in response to Minstar's unsolicited tender offer, amended the company's stock option and long-term incentive plan. The amendments granted AMF employees options to purchase AMF stock at favorable prices, conditioned on the consummation of a tender offer. The AMF board asserted that the amendments

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120 744 F.2d 255 (2d Cir. 1984).
121 *Id.* at 265. Piezo Electric Products, in conjunction with Rooney, Pace, began buying large blocks of Norlin stock, bringing their total ownership to 32%. *Id.* at 259. The Norlin Corp. directors voted to take defensive action in response to the fear that their company might soon be the target of an unsolicited takeover attempt. Their action included the creation of an ESOP. *Id.*
122 *Id.* at 266-67.
123 The board appointed three Norlin board members as trustees of the plan. *Id.* at 259. The board then transferred 185,000 shares of newly issued common stock into the ESOP in consideration for a promissory note. *Id.* By retaining beneficial ownership, the board effectively retained voting control of the shares it conveyed to the ESOP. *Id.*
124 *Id.*
125 The court affirmed the district court's finding that the illegality of voting the newly issued stock transferred to a wholly owned subsidiary and the ESOP had been demonstrated with sufficient certainty to warrant injunctive relief. *Id.* at 267, 269.
126 *Id.* at 266.
128 *Id.* at 1255.
129 Originally, the board planned to grant the options based upon stated employee performance objectives over a particular period. *Id.* Subsequent amendments dropped the performance requirements. Instead, a tender offer triggered the options. *Id.* at 1256. Holders could exercise the stock rights at either the highest price paid in a tender offer in
were intended to calm employee fears created by hostile takeover attempts and to safeguard rights and benefits already promised to AMF employees. The court, however, rejected these contentions. The court found that conditioning the option rights upon a change in control "raises a strong inference that AMF's board acted only to entrench itself."

Courts must recognize the legitimate concerns for employees of a target company, but must also require directors to demonstrate a genuine danger. If the directors meet this burden, and there is no evidence of self-dealing, courts should find that the directors fulfilled the danger element of their initial reasonableness burden.

C. Reasonable in Relation to the Danger

Directors enjoy wide latitude in devising strategies to resist unfriendly advances under the business judgment rule. Courts should, however, require directors to show that their action was reasonable in relation to a danger posed, and thus no more extensive than necessary.

In Unocal, the Unocal board responded to Mesa's inadequate and coercive offer by adopting a selective self-tender offer which excluded Mesa from participating. First, the Unocal board wanted to defeat Mesa's inadequate first-tier offer. Second, should Mesa's offer succeed, the board wanted to provide the forty-nine percent back-end shareholders, who would otherwise be forced to accept junk bonds, with $72 worth of senior debt.

Allowing Mesa to participate in the exchange offer would have frustrated the Unocal board's efforts. The Delaware court explained that if Mesa could tender its shares, Unocal would effectively subsidize Mesa's effort to buy Unocal shares at $54.

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130 Id.
131 Id. at 1261. The court explained that if the changes were prudent steps to safeguard the rights and benefits already earned and owed to AMF employees and to bring AMF in line with the plans of similar companies, then conditioning the plan on a change in control would have been unnecessary. Id.
132 Hanson II, 781 F.2d at 273 (citing Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984)).
133 Unocal, 493 A.2d at 955.
134 Id. at 950-51.
135 Id. at 956.
136 Id.
Moreover, the court stated that Mesa could not, by definition, fit within the class of shareholders requiring protection from its own coercive and inadequate tender offer.\textsuperscript{137} Because the selective nature of the self-tender was necessary to remove a genuine danger and to accomplish the goals of shareholder protection, the court concluded that the defensive tactic was reasonable in relation to the threat.\textsuperscript{138}

In \textit{Moran}, the Household board implemented a poison pill rights plan even though no tender offer had yet been made.\textsuperscript{139} Financial studies showed Household's current stock price was under-valued in relation to the company's break-up value. The board was concerned that Household was vulnerable to the dangers posed by the increasing frequency of bust-up takeovers and front-end loaded, two-tier tender offers in Household's industry.\textsuperscript{140}

The rights plan entitled each Household shareholder to receive one right for each share of common stock owned.\textsuperscript{141} The right, however, would issue and become immediately exercisable only when one of two possible triggering events occurred: first, if anyone acquired twenty percent of Household's outstanding common stock (twenty percent purchase trigger); or second, if anyone publicly announced a tender offer for at least thirty percent of Household's outstanding common stock (thirty percent offer trigger).\textsuperscript{142} If the thirty percent offer trigger occurred, the rights were still redeemable by the board for $.50 per right, but not if the twenty percent purchase trigger occurred.\textsuperscript{143}

The plan's poison pill effect derived from a provision granting stockholders different rights prior to and immediately after an acquiring company performed a business combination with Household. Once one of the two triggering events occurred, but before the business combination, the rights entitled a holder to purchase one-hundredth of a share of a new series of preferred stock for $100, or $10,000 per share.\textsuperscript{144} If, however, a stockholder did not exercise the right to purchase the preferred stock and a merger or other combination occurred, the rights would "flip-over" to the surviving company's capital structure, entitling the stockholder to purchase $200 of the common stock of the company for the $100

\textsuperscript{137} Id.
\textsuperscript{138} Id. On July 8, 1986, the SEC voted to prohibit selective self-tender offers. The SEC added § (f)(8)(i) (the "all-holders requirement") to Rule 13(e)-4 of the Williams Act, supra note 5. \textit{See} SEC Release Nos. 33-6653, 34-23421, IC-15199 (July 8, 1986).
\textsuperscript{139} Moran, 500 A.2d at 1348-49.
\textsuperscript{140} Id. at 1349.
\textsuperscript{141} Id. at 1348.
\textsuperscript{142} Id. at 1348-49.
\textsuperscript{143} Id. at 1349.
\textsuperscript{144} Id.
exercise price.\textsuperscript{145} The plan thus forced a raider to "swallow the pill," because once a business combination occurred and shareholders exercised the rights, the plan immediately diluted the raider's capital structure. In \textit{Moran}, the increase in financing a takeover of Household would have amounted to several billion dollars.\textsuperscript{146}

Moran argued that the plan was unreasonable in relation to the threats posed to Household. Moran contended that the rights plan caused Household shareholders to lose their right to receive and accept any tender offers, and did not only prevent bust-up and coercive takeovers.\textsuperscript{147} After finding that pre-takeover tactics are permissible,\textsuperscript{148} the Delaware court rejected Moran's contention. The court explained that the rights plan did not destroy assets or dilute corporate funds, it did not affect the company's stock market price, and it did not affect a shareholder's ability to conduct a proxy contest without triggering the rights.\textsuperscript{149} More importantly, the court noted that although the plan might deter some takeovers, it did not absolutely prevent shareholders from receiving tender offers, because in the event of an actual offer, the redemption clause of the rights plan would have enabled the Household board to use the plan as an effective bargaining tool.\textsuperscript{150} For example, the Household board could protect shareholders by conditioning the redemption of the rights on a bidder agreeing to pay all tendering shareholders adequate and equal consideration.\textsuperscript{151} To that extent, the Delaware Supreme Court in \textit{Moran} found that the rights plan, with its bargaining tool function, was a reasonable defensive measure adopted in relation to the threats posed even though no actual bid had been made.\textsuperscript{152}

Although the \textit{Moran} court found that the rights plan was reasonable in relation to the threat of bust-up takeovers,\textsuperscript{153} the court recognized that a board does not have unbridled discretion to implement a defensive tactic as a bargaining tool.\textsuperscript{154} Thus, courts must carefully examine the evidence to uncover situations where the directors are acting under a pretext of attempting to use a de-

\textsuperscript{145} \textit{Id.}
\textsuperscript{146} See Nat'l L.J., June 3, 1985, at 28, col. 2.
\textsuperscript{147} 500 A.2d at 1353-54.
\textsuperscript{148} \textit{Id.} at 1350.
\textsuperscript{149} \textit{Id.} at 1354-55.
\textsuperscript{150} \textit{Id.} at 1354.
\textsuperscript{151} \textit{Id.}
\textsuperscript{152} \textit{Id.} at 1357. The court also found that the directors made an informed decision to implement the rights plan. \textit{Id.} at 1356.
\textsuperscript{153} \textit{Id.} at 1357.
\textsuperscript{154} \textit{Id.} at 1354, 1357. See Dynamics Corp. v. CTS Corp., Nos. 86-1601, 86-1608 (7th Cir. June 9, 1986) (poison pill plan unreasonable under the circumstances).
fensive tactic as a bargaining tool for future takeover contests. In those situations where another motive is apparent, courts should not uphold directors’ actions as reasonable in relation to a threat.

In addition to judging the board’s action at the time of the adoption of the rights plan, the Moran court recognized that the board had to act reasonably if at a later date an actual offer was made. Referring to the board’s redemption power, the Delaware court stated that while the Household directors were presently protected by the business judgment rule, the “ultimate response to an actual takeover bid must be judged by the Directors’ actions at that time, . . . [and t]heir use of the Plan will be evaluated when and if the issue arises.”

Thus, if a board, upon reasonable investigation, found that an offer posed no danger to the company or its shareholders, it would have a duty to redeem the rights.

To meet their initial reasonableness burden, directors must show that their defensive action was reasonable in relation to a genuine danger posed by a bidder. The action must remove the danger but, because of the potential for shareholder gain from legitimate offers, it cannot exceed that which is necessary to remove the danger. Pre-takeover defensive action can also protect attractive companies and their shareholders by signaling to corporate raiders that they will not succeed where their tactics pose a threat. To meet the initial reasonableness burden, however, pre-takeover defensive measures should contain a feature enabling the board to use the measure as a bargaining tool when an actual takeover situation arises. Such a feature gives the board sufficient flexibility to deal, at a later time, with a bidder posing a legitimate danger while not completely deterring beneficial offers.

IV. Conclusion

Traditionally, directors have enjoyed broad power to make decisions concerning their company’s “business and affairs.” Recent decisions, however, suggest that courts will not reflexively give

155 500 A.2d at 1357.
156 In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., Nos. 353 & 354 (Del. March 13, 1986), the Revlon board instituted several defensive tactics in response to a takeover attempt by Pantry Pride, including a redeemable poison pill rights plan. The Revlon board was faced with a situation where it chose to redeem the rights. The Delaware Supreme Court noted that when the board adopted the rights plan, it was protecting shareholders from an inadequate bid, while retaining, through the redemption provision, sufficient flexibility to address any offer deemed within the shareholders’ best interest. Revlon, slip op. at 14.
157 The court in Moran noted that pre-takeover defensive measures might reduce the risk that the directors will fail to use their business judgment when under the pressure of an intense bidding contest. 500 A.2d at 1350.
158 See note 6 supra.
deference to the actions of directors in the face of a takeover threat. This is necessary in light of the continuing increase in unsolicited tender offers and the introduction of new and potent defense tactics.

Courts should require directors to initially present evidence showing that they had reasonable grounds for believing a danger to the company and its stockholders existed and, to ensure balance, that the action taken was reasonable in relation to the threat posed. The directors may then enjoy the presumption of the business judgment rule. Such a review should assure that directors act in the best interests of the company and its shareholders. The proper balance will enable stockholders to enjoy their basic right to transfer their ownership interests, while allowing directors to protect against genuine dangers to the company and its shareholders. This will also allow a court to give some deference to a board's decision without substituting its judgment for that of a board acting reasonably.

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159 When a board cannot effectively remove a perceived danger, the board's duty of protection changes. Accordingly, situations involving unavoidable dangers require a modification of the target board's initial reasonableness burden. An unavoidable danger may occur when it becomes apparent that a bidder intends to succeed at any cost in acquiring a company at an inadequate price and eventually break up the company. Because the board cannot effectively remove the danger, the board's duty changes from protection to acting as a corporate auctioneer to attract the best bid for the benefit of shareholders. Thus, instead of demonstrating a perceived danger and showing a reasonable defensive measure adopted to remove the danger, directors must show, to meet their initial reasonableness burden, that their primary concern was for the interests of shareholders and that they took reasonable action to allow and invite competing bids. The board can then enjoy the protections of the business judgment rule. In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., Nos. 353 & 354 (Del. March 13, 1986), the court enjoined a lock-up option the Revlon board granted to a white knight as a defensive measure. The court found that Pantry Pride, a hostile bidder, posed an unavoidable danger which even the board recognized. The court held that the directors did not meet their modified initial reasonableness burden because the lock-up option ended an intense bidding contest in return for very little improvement in the final bid to shareholders, and only protected the directors and certain Revlon noteholders from personal liability. Revlon, slip op. at 17-25.