**Course:**  
*Corporations and Corporate Governance*  

**Contents:**  
*Reading Materials, Session Six: Directors’ Fiduciary Duties and the Sale of the Firm*

**Instructor:**  
Professor Robert J. Jackson, Jr.  

**Meeting Details:**  
Wednesday, July 27, 12:45 to 2:45 PM  
Jerome Greene Hall

**Readings:**

With the nuts-and-bolts law needed to structure a merger under our belts, we will turn after lunch to perhaps the most contested subject in American corporate law: What are the fiduciary duties of the board of directors when an acquirer wants to buy the firm over the board’s objection—that is, on a “hostile” basis?

We will begin by considering the key common-law cases in this area before examining the policy considerations behind those decisions. To prepare for this session, please review:


I very much look forward to discussing these materials with you on Wednesday afternoon.
13.1 Introduction

Control contests occupy a central place in the theory of U.S. corporate governance. Stock prices fall when companies fail to perform well, and cheap stock presents an opportunity to those who believe they could do better than the incumbent managers, driven by any of the several motivations for acquisitions that we reviewed in Chapter 12. Thus, control contests create important opportunities. They give acquiring managers the opportunity to capitalize on the new value created by different plans or better skills, and they give target shareholders the opportunity to share in this new value. The flip side, however, is that control contests are profoundly unpleasant for incumbent managers. But for this very reason, the threat of a takeover has the salutary effect of encouraging all managers to deliver shareholder value. Thus, control contests are an important potential constraint on manager-shareholder agency costs generally.

Law is one of the principal determinants of the scope of the takeover market. Traditionally, Anglo-American law opened two avenues for initiating a hostile change in control. The first was the proxy contest — the simple expedient of running an insurgent slate of candidates for election to the

---

1. Credit for first articulating the key governance role of control costs must go to Henry Manne. See Henry Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965). For subsequent development of the governance role of control contests, see two classic articles from the early 1980s: Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to Hostile Takeovers, 94 Harv. L. Rev. 1161 (1981); and Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819 (1981). Hostile takeovers grew less important in the United States during the 1990s, even while the overall incidence of M&A transactions increased dramatically. Worldwide, however, hostile takeovers grew more important. For example, the largest hostile takeover ever is the acquisition of a German public company, Mannesmann, A.G., by a British upstart, Vodafone, PLC, in 1999. After Vodafone acquired Mannesmann, the German Parliament passed significant new antitakeover legislation. Ask yourself, as you read through this chapter, how far this European development recapitulates the American experience.
board. Although the proxy contest was costly and often unsuccessful (at least at first), it was nevertheless the only insurgent technique employed during the infrequent contests for control over widely held companies prior to the 1960s. Moreover, the proxy contest has returned with the rise of hedge funds—large pools of unregulated investment money—in the hands of activist investors who are using proxy fights as an important tool. For hedge funds, however, the most common strategy is not to pursue a complete takeover but rather a partial slate of directors who will promote change through “constructive engagement” with the other members of the board.

The second technique was the tender offer—the even simpler expedient of purchasing enough stock oneself to obtain voting control rather than soliciting the proxies of others. Widespread use of this technique dates from the 1960s, and it has remained important ever since. Clearly, a tender offer is even costlier than a proxy contest, but it also has a great comparative advantage in capturing the attention of stockholders with its promise of cash up front rather than promises of future performance. In recent years, moreover, the proxy contest and the tender offer have often merged into a single hybrid form of hostile takeover, as the law’s acceptance of increasingly potent defensive tactics has made it difficult to pursue either avenue alone.

The law of corporate control contests has developed in tandem with the steep rise in the number of M&A transactions in the U.S. economy over the past thirty years. At the outset of this period, courts reviewed the board’s response to a contest for control just as they would review any other corporate action. If the response were self-interested in an immediate financial way, the board would be required to demonstrate that it was intrinsically fair; otherwise, it would be reviewed under the business judgment standard. From a practical perspective, however, this approach worked poorly for mergers or other acquisition-of-control transactions—and, by extension, for efforts to foreclose hostile takeovers. Management and the board are never truly disinterested in the efforts to acquire control over the corporation (and hence over their positions). Nevertheless, responses to takeover offers are not “self-interested” to the same extent as a self-dealing transaction. These offers are immensely complicated business propositions that can expose shareholders to serious risks of exploitation by third-party bidders.

The Delaware Supreme Court first began to grapple seriously with the complexities of the board’s duties in contests for corporate control in a series of three cases argued during 1985, which together set the framework for the analysis of directors’ fiduciary duties in M&A transactions and for

2. Even in those instances in which incumbent managers defeat a proxy fight, history shows that there is a relatively strong probability that incumbent management will be changed within the following year.
13.1 Introduction

defenses against hostile takeovers. Each of these cases involved a different doctrinal question, but all concerned changes in corporate control. The wisdom of hindsight suggests that they were all aspects of a single effort to bring meaningful judicial review to control transactions. The first case was Smith v. Van Gorkom, which arose out of a friendly two-step acquisition, consisting of a cash tender offer followed by a cash-out merger. On its face, Van Gorkom appears to be chiefly about the corporate director's duty of care. Nevertheless, Van Gorkom held an entire board liable for "gross negligence" under circumstances in which most experts would have said its directors bad met their standard of care; that is, they had attended all meetings and deliberated about the key corporate decisions at issue. To better understand this surprising case, we suggest looking at it in the context of the law of mergers. Later cases make clear that during this period the Delaware Supreme Court began a project of redefining the role of the corporate board in corporate control transactions.

The second major decision was Unocal Corp. v. Mesa Petroleum Co., which is excerpted below. It dealt with the Unocal board's efforts to defend against a hostile tender offer Unocal articulated for the first time a standard of judicial review intermediate between lax business judgment review and tough entire fairness review to address board efforts to defend against a threatened change-in-control transaction.

The third significant case argued in 1985 was Revlon v. MacAndrews and Forbes Holdings, Inc. Revlon also addressed the efforts of an incumbent board to resist an unwelcome takeover. Revlon's board, however, attempted to resist by pursuing an alternative transaction, which is the focus of the case. Again, the court adopted a form of heightened review short of intrinsic fairness. For want of better terminology, lawyers and judges came to talk of "Revlon duties," "Revlonland," and "Revlon mode" for those times when similar duties arose. Yet no one was certain when a board had entered Revlonland or exactly what the new Revlon duties required.

Although these 1985 cases appeared revolutionary to some, they had precursors: two earlier cases that sought to introduce flexibility into the business judgment rule/entire fairness dichotomy. The first was Cheff v. Mathes, a 1964 Delaware Supreme Court opinion in which shareholders attacked a corporate repurchase at a premium price of all the stock belonging to a dissident shareholder/director. The court agreed that the repurchase had the effect of securing the directors in control but held that, as long as the board's primary purpose was to advance business policies, the buyback did not violate the board's fiduciary duty.

5. 488 A.2d 858 (Del. 1985). See the discussion in Chapter 8.
8. 199 A.2d 548 (Del. 1964).
9. The shareholder attacked the corporation marketing strategy, which management defended as a source of real value. The board resolved the disagreement by causing the company to repurchase the dissident's stock at a premium over market price. Plaintiff shareholders claimed that this purchase was wasteful, since the company paid a premium to market price, and that the repurchase was made to entrench the directors in office.
France, Spain, and the UK have opted in to Article 9, while Germany and the Netherlands have opted out, among the larger EU member states.

The second key provision of the Takeover Directive is the so-called breakthrough rule embodied in Article 11. Under the breakthrough rule, a hostile acquirer that obtains more than 75 percent of voting equity of a target company could remove the board of directors, regardless of any restrictions on the voting rights in the charter (including differential voting rights among multiple classes of stock) and any restrictions on the transfer of securities. All shares vote equally on charter amendments proposed by such an acquirer. In addition, multiple voting class structures and restrictions on shareholder votes are unenforceable under Article 11 against the bidder in a takeover, and do not apply to target shareholders who must vote on defensive measures. Most EU members (e.g., France, Germany, Italy, the Netherlands, Spain, UK) have opted out of Article 11.


13.2 Defending Against Hostile Tender Offers

UNOCAL. CORP. v. MESA PETROLEUM CO.
493 A.2d 946 (Del. 1985)

MOORE, J.: We confront an issue of first impression in Delaware — the validity of a corporation’s self-tender for its own shares which excludes from participation a stockholder making a hostile tender offer for the company’s stock. . . .

On April 8, 1985, Mesa, the owner of approximately 13% of Unocal’s stock, commenced a two-tier “front loaded” cash tender offer for 64 million shares, or approximately 37%, of Unocal’s outstanding stock at a price of $54 per share. The “back-end” was designed to eliminate the remaining publicly held shares by an exchange of securities purportedly worth $54 per share. However, pursuant to an order entered by the United States District Court for the Central District of California on April 26, 1985, Mesa issued a supplemental proxy statement to Unocal’s stockholders disclosing that the securities offered in the second-step merger would be highly subordinated, and that Unocal’s capitalization would differ significantly from its present structure. Unocal has rather aptly termed such securities “junk bonds.”

Unocal’s board consists of eight independent outside directors and six insiders. It met on April 13, 1985, to consider the Mesa tender offer. Thirteen directors were present, and the meeting lasted nine and one-half hours. The directors were given no agenda or written materials prior to the session. However, detailed presentations were made by legal
counsel regarding the board’s obligations under both Delaware corporate law and the federal securities laws. The board then received a presentation from Peter Sachs on behalf of Goldman Sachs & Co. (Goldman Sachs) and Dillon, Read & Co. (Dillon Read) discussing the bases for their opinions that the Mesa proposal was wholly inadequate. Mr. Sachs opined that the minimum cash value that could be expected from a sale or orderly liquidation for 100% of Unocal’s stock was in excess of $60 per share.

Mr. Sachs also presented various defensive strategies available to the board if it concluded that Mesa’s two-step tender offer was inadequate and should be opposed. One of the devices outlined was a self-tender by Unocal for its own stock with a reasonable price range of $70 to $75 per share. The cost of such a proposal would cause the company to incur $6.1-6.5 billion of additional debt, and a presentation was made informing the board of Unocal’s ability to handle it. The directors were told that the primary effect of this obligation would be to reduce exploratory drilling, but that the company would nonetheless remain a viable entity.

The eight outside directors, comprising a clear majority of the thirteen members present, then met separately with Unocal’s financial advisors and attorneys. Thereafter, they unanimously agreed to advise the board that it should reject Mesa’s tender offer as inadequate, and that Unocal should pursue a self-tender to provide the stockholders with a fairly priced alternative to the Mesa proposal.

On April 15, the board met again. Unocal’s Vice President of Finance and its Assistant General Counsel made a detailed presentation of the proposed terms of the exchange offer. A price range between $70 and $80 per share was considered, and ultimately the directors agreed upon $72. The board’s decisions were made in reliance on the advice of its investment bankers. Based upon this advice, the directors unanimously approved the exchange offer. Their resolution provided that if Mesa acquired 64 million shares of Unocal stock through its own offer (the Mesa Purchase Condition), Unocal would buy the remaining 49% outstanding for an exchange of debt securities having an aggregate par value of $72 per share. The board resolution also stated that the offer would be subject to other conditions.

Legal counsel advised that under Delaware law Mesa could only be excluded for what the directors reasonably believed to be a valid corporate purpose. The directors’ discussion centered on the objective of adequately compensating shareholders at the “back-end” of Mesa’s proposal, which the latter would finance with “junk bonds.” To include Mesa would defeat that goal, because under the proration aspect of the exchange offer (49%) every Mesa share accepted by Unocal would displace one held by another stockholder. Further, if Mesa were permitted to tender to Unocal the latter would in effect be financing Mesa’s own inadequate proposal.

[Unocal’s board subsequently waived the Mesa Purchase Condition as to 50 million shares (roughly 30 percent of outstanding shares), five days after the commencement of its April 17 exchange offer. This waiver—in effect, a self-tender for 30 percent of Unocal—was meant to placate]
in institutional shareholders who correctly anticipated that Unocal's offer would defeat Mesa's bid and feared that it would also lead stock prices to decline to the $50 level, where they had languished prior to Mesa's bid.

We begin with the basic issue of the power of a board of directors of a Delaware corporation to adopt a defensive measure of this type....

The board has a large reservoir of authority upon which to draw. Its duties and responsibilities proceed from the inherent powers conferred by 8 Del. C. §141(a), respecting management of the corporation's "business and affairs." Additionally, the powers here being exercised derive from 8 Del. C. §160(a), conferring broad authority upon a corporation to deal in its own stock. From this it is now well established that in the acquisition of its shares a Delaware corporation may deal selectively with its stockholders, provided the directors have not acted out of a sole or primary purpose to entrench themselves in office. Cheff v. Mathes, Del. Supr., 199 A.2d 548, 554 (1964)....

Finally, the board's power to act derives from its fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived, irrespective of its source....

When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interest of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment.... There are, however, certain caveats to a proper exercise of this function. Because of the omnipresent specter 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....

In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership....

[C]orporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders.... As we have noted, their duty of care extends to protecting the corporation and its owners from perceived harm whether a threat originates from third parties or other shareholders. But such powers are not absolute. A corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available.

The restriction placed upon a selective stock repurchase is that the directors may not have acted solely or primarily out of a desire to perpetuate themselves in office... [or take] inequitable action....

10. It has been suggested that a board's response to a takeover threat should be a passive one. Easterbrook & Fischel, supra, 36 Bus. Law. at 1750. However, that clearly is not the law of Delaware, and as the proponents of this rule of passivity readily concede, it has not been adopted either by courts or state legislatures. Easterbrook & Fischel, supra, 94 Harv. L. Rev. at 1194 (1981).
A further aspect is the element of balance. If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of non-consummation, and the quality of securities being offered in the exchange. See Lipton and Brownstein, Takeover Responses and Directors' Responsibilities: An Update, p. 7, ABA National Institute on the Dynamics of Corporate Control (December 8, 1983). While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor. Here, the threat posed was viewed by the Unocal board as a grossly inadequate two-tier coercive tender offer coupled with the threat of greenmail.

Specifically, the Unocal directors had concluded that the value of Unocal was substantially above the $54 per share offered in cash at the front end. Furthermore, they determined that the subordinated securities to be exchanged in Mesa's announced squeeze out of the remaining shareholders in the "back-end" merger were "junk bonds" worth far less than $54. It is now well recognized that such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction. Wholly beyond the coercive aspect of an inadequate two-tier tender offer, the threat was posed by a corporate raider with a national reputation as a "greenmailer." 13

In adopting the selective exchange offer, the board stated that its objective was either to defeat the inadequate Mesa offer or, should the offer still succeed, provide the 49% of its stockholders, who would otherwise be forced to accept "junk bonds", with $72 worth of senior debt. We find that both purposes are valid.

However, such efforts would have been thwarted by Mesa's participation in the exchange offer. First, if Mesa could tender its shares, Unocal would effectively be subsidizing the former's continuing effort to buy Unocal stock at $54 per share. Second, Mesa could not, by definition, fit

11. There has been much debate respecting such stockholder interests. One rather impressive study indicates that the stock of over 50 percent of target companies, who resisted hostile takeovers, later traded at higher market prices than the rejected offer price, or were acquired after the tender offer was defeated by another company at a price higher than the offer price. See Martin Lipton, [Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101 (1979)] at 106-109, 122-133. Moreover, an update by Kidder Peabody & Company of this study, involving the stock prices of target companies that have defeated hostile tender offers during the period from 1975 to 1982 demonstrates that in a majority of cases the target's shareholders benefited from the defeat. . . .

13. The term "greenmail" refers to the practice of buying out a takeover bidder's stock at a premium that is not available to other shareholders in order to prevent the takeover. . . .
within the class of shareholders being protected from its own coercive and inadequate tender offer.

Thus, we are satisfied that the selective exchange offer is reasonably related to the threats posed. ... Thus, the board's decision to offer what it determined to be the fair value of the corporation to the 49% of its shareholders, who would otherwise be forced to accept highly subordinated "junk bonds", is reasonable and consistent with the directors' duty to ensure that the minority stockholders receive equal value for their shares.

Mesa contends that it is unlawful, and the trial court agreed, for a corporation to discriminate in this fashion against one shareholder. It argues correctly that no case has ever sanctioned a device that precludes a raider from sharing in a benefit available to all other stockholders. However, as we have noted earlier, the principle of selective stock repurchases by a Delaware corporation is neither unknown nor unauthorized. ... The only difference is that heretofore the approved transaction was the payment of "greenmail" to a raider or dissident posing a threat to the corporate enterprise. All other stockholders were denied such favored treatment, and given Mesa's past history of greenmail, its claims here are rather ironic.

However, our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs. ...

As the sophistication of both raiders and targets has developed, a host of other defensive measures to counter such ever-mounting threats have evolved and received judicial sanction. These include defensive charter amendments and other devices bearing some rather exotic, but apt, names: Crown Jewel, White Knight, Pac Man, and Golden Parachute. Each has highly selective features, the object of which is to deter or defeat the raider.

Thus, while the exchange offer is a form of selective treatment, given the nature of the threat posed here the response is neither unlawful nor unreasonable. If the board of directors is disinterested, has acted in good faith and with due care, its decision in the absence of an abuse of discretion will be upheld as a proper exercise of business judgment. ...

In conclusion, there was directorial power to oppose the Mesa tender offer, and to undertake a selective stock exchange made in good faith and upon a reasonable investigation pursuant to a clear duty to protect the corporate enterprise. Further, the selective stock repurchase plan chosen by Unocal is reasonable in relation to the threat that the board rationally and reasonably believed was posed by Mesa's inadequate and coercive two-tier tender offer. Under those circumstances the board's action is entitled to be measured by the standards of the business judgment rule. Thus, unless it is shown by a preponderance of the evidence that the directors' decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed, a Court will not substitute its judgment for that of the board.

If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out.
1. What does it mean to characterize the Mesa offer as “coercive”? How can Mesa’s two-tier offer be coercive if the prebid market price for Unocal shares was, say, $33/share, Pickens’s cash price for 37 percent of Unocal was $55/share, and Pickens’s back-end cash-out price for the remaining 50 percent of Unocal’s shares was around $45/share (the likely market value of junk bonds with a face value of $55/share)? Even the “back end” of the Pickens offer was generally acknowledged to be worth a lot more than Unocal’s prebid market price.

2. Was the Unocal exchange offer also coercive? Which offer would you have valued more as a shareholder?

3. What was the logical relevance of Mesa’s reputation as a greenmailer to the court’s analysis?

4. What are we to make of a discriminatory self-tender? Is it any different from greenmail, which the Delaware Supreme Court had authorized to protect corporate policies since the Cheff case? The SEC presumably thought so, since it effectively overruled this aspect of Unocal by promulgating Rule 13e-4, which bars discriminatory self-tenders. No SEC rule bars greenmail.

5. Is Justice Moore abandoning shareholder primacy in this opinion? Is the fundamental duty of boards to further the interests of shareholders, to balance the interests of all corporate “constituencies,” or to do something in between?

6. In footnote 11 of its opinion the Court cites empirical evidence from Martin Lipton and Kidder Peabody indicating that targets remaining independent achieve higher returns for their shareholders than targets that sell to the hostile bidder. The Court does not cite Professor Ronald Gilson, who points out several flaws in Lipton’s study, including no adjustment for market effects or the time value of money. When these and other factors are considered, Gilson states that “Lipton’s data refute his own conclusion.” A more recent study, examining targets that remained independent between 1996 and 2002, shows that shareholders received lower returns than they would have received if the company had been sold to the initial bidder or to a white knight—the opposite of what Lipton and Kidder Peabody found twenty years earlier. In general, how should courts utilize empirical evidence in formulating their opinions? For one judge’s perspectives on this “meta-question,” see Jack B. Jacobs, Comments on Contestability, 54 U. Miami L. Rev. 847 (2000).

7. Unocal announces a new standard for reviewing defensive tactics—what the Delaware Supreme Court refers to as “enhanced business judgment review.” To earn the protection of the business judgment rule, the board must show that its defensive tactic was “reasonable in relation to the threat posed.” How different is this standard from old-fashioned business

In the 1995 case Unitrin v. American General Corp.,14 the Delaware Supreme Court classified to some extent what “reasonable in relation to the threat posed” means. The case involved a hostile tender offer by American General Corp. (AmGen) for Unitrin at $50 3/8 per share, a substantial premium to market price. Unitrin’s board was comprised of seven persons, who collectively owned 23 percent of the company’s stock.

After concluding that AmGen’s offer was inadequate, Unitrin’s board sought to defend by implementing a poison pill, an advance-notice bylaw,15 and a tender offer to repurchase five million, or 20 percent, of its outstanding shares. Unitrin’s directors announced that they would not participate in this buyback, which, if successful, would increase their proportional share ownership to 28 percent of Unitrin’s outstanding stock. Unitrin’s charter mandated that any transaction with an entity controlled by or affiliated with a person owning 15 percent of Unitrin’s stock required approval by 75 percent of the outstanding stock.

The Chancery Court held that the AmGen offer represented a threat of “substantive coercion.”16 This Orwellian phrase meant that (the board believed) shareholders might be “coerced” because they would not fully understand the value of their stock or the inadequacy of the consideration offered. Applying Unocal, the court held that the pill was a proportional response to this threat but that the repurchase program was not. Increasing the management block from 23 percent to 28 percent of the shares by repurchases would, according to the court, preclude a change in control as a practical matter. The court concluded that this response was “unnecessary” in light of what was only a “mild” threat.

On appeal, the Delaware Supreme Court reversed. Justice Holland held that “if the board of directors’ defensive response is not draconian (preclusive or coercive) and is within a range of reasonableness,” a court

15. Advance-notice bylaws generally require any stockholder who intends to nominate an insurgent slate at the next annual shareholders’ meeting to give certain information to the corporation concerning the identity of such persons well in advance of the meeting. Sometimes the mandated time is 90 days, but often it is longer, 120 days or more. Obviously, as the period increases, so does the constraint on proxy contests. Some such bylaws will be validly subject to a claim that they constitute a manipulation foreclosed by the Schnell principle.
16. This phrase was coined in Ronald J. Gilson & Reinier Kraakman, Delaware’s Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?, 44 Bus. Law. 247, 267 (1989). Although the article advocated “a meaningful proportionality test” when a board alleged substantive coercion, the Unitrin court seems to have adopted the term “substantive coercion” without the accompanying hard look at “how—and when—management expects a target’s shareholders to do better.” Id. at 268. See also Chesapeake v. Shore, 771 A.2d 295, 329 (Del. Ch. 2000) (Strine, V.C.) (noting the tension).