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Recent Judicial Developments in Delaware Takeover Law

by Mark J. Loewenstein

In the past few years, several Delaware cases have considered the permissible defensive tactics available to corporate directors confronted with a hostile takeover attempt. In judging defensive responses, the courts' primary focus has been on three issues:

- 1) whether the takeover poses a threat to the company;
- 2) whether the defensive tactic is reasonable in relation to the threat posed; and
- 3) under what circumstances directors have a duty to become auctioneers of their company.

This article discusses the recent judicial developments in Delaware takeover law. Because of the large number of companies incorporated in Delaware, attorneys in the area of business law and their corporate clients should keep abreast of these developments.

Three Key Decisions

In 1985 and 1986, the Delaware Supreme Court handed down three decisions that are now widely recognized as the basis for analyzing defenses to hostile takeover attempts. In the first, *Unocal Corp. v. Mesa Petroleum Corp.*,¹ the court held that directors of a company that was the subject of a hostile takeover attempt could take defensive measures if (1) the takeover posed a threat

to the company and (2) the defensive measures were reasonable in relation to the threat posed.

The court then applied its *Unocal* rules in *Moran v. Household International, Inc.*,² holding that a defensive maneuver—in this case a “poison pill”³—could be adopted even in the absence of a hostile bid. The court affirmed the lower court's findings that the poison pill adopted by Household was a reasonable response to the threat that the directors perceived, a possibly unfavorable hostile takeover of the company.

After reviewing responses by targeted corporations to actual and feared bids, the court turned its attention to a third scenario, an instance in which two or more bidders seek control of a company. In *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*,⁴ the court held that when events make the sale of the company inevitable, the role of the targeted corporation's directors shifts from preservers of the company's independence to auctioneers who should seek to maximize the value of the company. In *Revlon*, the court affirmed the granting of an injunction against maneuvers that ended the bidding by a bidder Revlon did not favor and which assured the success of a bidder favored by Revlon's management.

Although the Delaware Supreme Court has issued opinions in only two other takeover cases since *Revlon*, the Delaware Chancery Courts have issued numerous opinions testing the general rules of *Unocal*, *Household* and *Revlon*.⁵ These opinions explore what constitutes a “threat” and what is a “reasonable re-

sponse” under the *Unocal* rubric; when the *Revlon* auction duties arise; and other issues left unanswered by the Delaware Supreme Court. Some of these issues are discussed in the following sections.

The Definition of a “Threat”

The threat in the *Unocal* case was clear: Mesa's offer was two-tiered and coercive. Mesa had offered cash for a controlling interest in Unocal and had planned a second-step merger that would have provided the shareholders with junk bonds for their remaining shares. Shareholders who did not accept the “front-end” cash offer would be forced out of the company with junk bonds. Consequently, all shareholders would feel coerced into accepting Mesa's offer in order to maximize their return. The court ruled that this coercive aspect of Mesa's offer justified Unocal's defensive response.

Subsequent cases have rarely presented facts as compelling as those in *Unocal* concerning whether a threat is pres-

This newsletter is prepared by the Business Law Section of the Colorado Bar Association to apprise members of the Bar of current information concerning substantive areas of business law. This month's column was written by Mark J. Loewenstein, Boulder, associate dean and associate professor at the University of Colorado School of Law.

ent. Nevertheless, the Delaware courts consistently have upheld the determination of targeted corporation directors that a hostile bid posed a threat to their company, as long as the directors acted in good faith and exercised due care in reaching that determination.⁶ The most telling example of this deference came earlier in 1989 in *Shamrock Holdings, Inc. v. Polaroid Corporation*.⁷

Shamrock offered to buy all of the outstanding shares of Polaroid at a cash price representing a handsome premium over the pre-offer market price. In addition, Shamrock promised to pay the same price, in cash, in a second-step merger for the Polaroid shares not tendered. When Polaroid planned defensive maneuvers, including a self-tender and the placement of a large block of preferred shares in friendly hands, Shamrock moved to enjoin these actions.

Polaroid argued that the price offered by Shamrock was inadequate because it failed to reflect fairly the value of Polaroid's patent infringement claim against Kodak. Polaroid contended that, because its shareholders might accept this inadequate price, the offer posed a threat to them. The court expressed doubt that a non-coercive offer at an allegedly inadequate price could ever pose a threat but, nevertheless, upheld the determination of the Polaroid directors. Polaroid persuasively argued that the Polaroid-Kodak litigation was so complex that shareholders might not properly evaluate its worth to Polaroid and therefore might accept an inadequate offer.

Shamrock and other cases demonstrate that directors should have little trouble persuading a Delaware court that a hostile offer poses a threat to the company.⁸ However, directors of targeted corporations have had less success persuading the Delaware courts that their defensive responses were reasonable in relation to the threats posed.

Reasonableness of The Response

Four recent Delaware cases have found defensive maneuvers unreasonable in relation to the threat posed.⁹ Two cases involved poison pills, one involved a self-tender and one involved a restructuring. In each of the four cases, the identified threat was an inadequate offer and the Chancery Court ruled that the shareholders should be given the opportunity to accept the tender offer. These cases suggest that once a company is "in

play," its directors cannot take defensive action solely to end the bidding.

Other cases, in which the Delaware courts refused the bidder's request for injunctive relief, are not necessarily inconsistent with this conclusion about unreasonable defensive actions. In several cases, the courts have cited as a reason for denying relief the fact that the bidding was proceeding despite the objectionable defensive maneuver and that injunctive relief therefore was unnecessary *at that time*.¹⁰

"Several recent Delaware cases suggest that once a company is 'in play,' its directors cannot take defensive action solely to end the bidding."

The Delaware courts are more reluctant to interfere or to suggest that interference may be appropriate when the objectionable action by the target is part of a *bona fide*, long-term business plan, as opposed to maneuvers undertaken solely to defeat an unwanted tender offer. The recent Paramount-Time litigation illustrates this notion.

The Time v. Paramount Decision

In March 1989, Time, Inc. and Warner Communications entered into a merger agreement under which Warner shareholders would exchange their stock for shares of Time, which would be the surviving corporation. The agreement was part of Time's long-term strategy to expand its activities into video and film production. It was the result of extended negotiations between the two companies. On June 7, 1989, Paramount Communications announced an offer to purchase all of Time's outstanding shares at \$175 per share, which was later increased to \$200 per share.

In response to this uninvited offer, Time and Warner agreed to restructure their deal. Instead of a merger, which would require the approval of Time's shareholders, they agreed on a tender offer by Time for Warner's shares, which would not require shareholder approval. Time shareholders and Paramount sued to enjoin the Time tender offer arguing, among other things, that the tender offer was an unreasonable response to Paramount's offer.

In a lengthy opinion, the Delaware Chancery Court denied Paramount's request.¹¹ The Delaware Supreme Court affirmed the denial.¹² The Chancery Court chose to treat the restructured Time-Warner tender offer as a defensive response to which the "heightened scrutiny" of *Unocal* applied.¹³

The Time directors were able to prevail under the higher standard of *Unocal* because the court was persuaded that the original Time-Warner merger was a legitimate business decision undertaken to maximize the long-term value of Time. The resulting Time tender offer, although reactive to the Paramount tender offer, bore scrutiny as a necessary step to the realization of Time's long-term plan. The Time tender offer was reasonable, the court said, because it did not preclude the successful prosecution of the tender offer.¹⁴

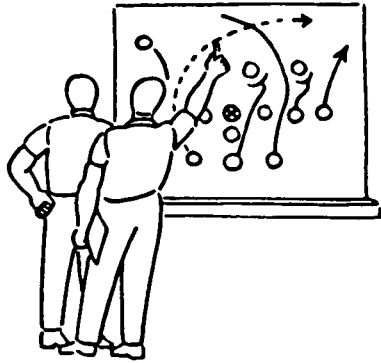
Two themes, which are consistent with earlier Delaware decisions, emerge from this opinion. First, a defensive action that is designed primarily to defeat a hostile offer is less likely to survive the scrutiny of the court than one which is based on an identifiable long-term business plan.¹⁵ Second, defensive action which precludes a tender offer is more suspect than one which merely makes the acquisition more expensive or changes the form of the acquisition.¹⁶ Thus, the Time-Paramount litigation also touched on the issues relating to an auction.

Revlon Duties: Directors As Auctioneers

The Time-Paramount litigation raised the question of when *Revlon* duties apply—that is, at what point the directors become auctioneers for their company. The Time shareholders argued that the original Time-Warner merger was, in effect, a sale of Time because the exchange ratio would mean that Warner shareholders, as a group, would own a larger portion of the combined entity than Time shareholders. Considering this, they argued, the Time directors should seek to maximize the value of the company by conducting an auction.

The Chancery Court rejected this argument, holding instead that "control" of Time really would not change as a result of the proposed Time-Warner merger. The court stated that control remained in a "large, fluid, changeable and changing market."¹⁷

Other *Revlon* issues were addressed by the Delaware Supreme Court in a



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1989 case, *Mills Acquisition Co. v. Macmillan, Inc.*¹⁸ In this case, the court set aside an asset lockup and no-shop agreement granted by Macmillan to one of two bidders for the company. In so doing, the court reaffirmed its earlier holding in *Revlon* and provided some additional guidance on the conduct of an auction for corporate control.

As to granting a lockup that ends the bidding process, the court said, "[A]t the very least the independent members of the board must attempt to negotiate alternative bids before granting such a significant concession."¹⁹ A "no-shop" clause, the court said, "is even more limited than a lockup agreement. . . . [A] successful bidder imposing such a condition must be prepared to survive the careful scrutiny which that concession demands."²⁰ In short, the Delaware Supreme Court will not tolerate the granting of concessions to a favored bidder unless the board of the targeted corporation can persuade the court that the shareholders clearly benefit.

Conclusion

The considerable litigation regarding takeovers in the Delaware courts has provided practitioners nationwide with numerous precedents to consider when structuring takeovers and defenses against them. Nevertheless, many issues remain unresolved. It is still unclear, for example, whether a Delaware corporation can "just say no" to a hostile takeover and resist it with a structural defense. Some cases in the Chancery Court suggest that a corporation cannot. Similarly, at this writing, it is unclear exactly what will trigger the *Revlon* auction duties. These and other issues will surely be resolved in the apparently endless stream of takeover cases coming before the Delaware courts.

NOTES

1. 493 A.2d 946 (Del. 1985).
2. 500 A.2d 1346 (Del. 1985).
3. A poison pill is a generic description for a takeover defense that makes the acquisition of the target company unacceptable to the acquiror. For example, the board of the targeted corporation might distribute rights to the shareholders which entitle them to purchase shares in the target or, under certain circumstances, shares of an acquiror, at a significant discount from market value. The financial effects resulting from an exercise of the rights are typically so significant that an acquiror does not proceed with the acquisition while the rights are in effect. Therefore,

the acquiror finds it necessary to negotiate with the target's board, which is the purpose of the poison pill. See, generally, 1 Fleischer, *Tender Offers: Defenses, Responses, and Planning* (1983, revised 1985 and 1987), § 1.9.c.

4. 506 A.2d 173 (Del. 1986).

5. See, notes 8 and 9, *infra*.

6. The *Unocal* decision suggested this result, as the court said that directors can show that they "had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another's stock ownership . . . 'by showing good faith and reasonable investigation.'" *Supra*, note 1 at 955 (quoting, *Cheff v. Mathes*, 199 A.2d at 555).

7. [1988-89 Transfer Binder] *Fed. Sec. L.Rep.* (CCH) ¶ 94,340 (Del.Ch. 1989).

8. See, e.g., *AC Acquisition Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del.Ch. 1986). Apparently, the threat in this case was the possibility of a change in control of the targeted company. If this is correct, there is no need to identify a threat.

9. *Grand Metropolitan PLC v. Pillsbury*, [1988-89 Transfer Binder] *Fed. Sec. L.Rep.* (CCH) ¶ 94,104 (Del.Ch. 1989) (ordering redemption of poison pill to allow shareholders to accept tender offer); *City Capital Associates Limited Partnership v. Interco, Inc.*, [1988-89 Transfer Binder] *Fed. Sec. L.Rep.* (CCH) ¶ 94,084 (Del.Ch. 1988) (ordering redemption of poison pill so shareholders could choose between tender offer and target's proposed restructuring); *Robert M. Bass Group, Inc. v. Evans*, [1988-89 Transfer Binder] *Fed. Sec. L.Rep.* (CCH) ¶ 93,924 (Del.Ch. 1988) (enjoining proposed restructuring because it precluded shareholder acceptance of arguably superior tender offer); *AC Acquisition Corp.*, *supra*, note 8 (enjoining self-tender because of its coercive aspects).

10. See, e.g., *MAI Basic Four, Inc. v. Prime Computer, Inc.*, Civ. Action No. 10428 (Del.Ch. 1988) (Plaintiff MAI's motion for preliminary injunction requiring removal of anti-takeover maneuvers, including poison pill, was denied. The court noted that such relief "at this early stage" would be inappropriate, but implied that should the "stalemate" continue indefinitely, the target's stockholders "will be denied the opportunity to make their own investment judgment."); *Doskocil Cos. Inc. v. Griggy*, Civ. Action No. 10,095 (Del.Ch. 1988) (motion to require redemption of poison pill denied, as its presence may enhance the auction process); *Facet Enterprises, Inc. v. The Prospect Group, Inc.*, Civ. Action No. 9746 (Del.Ch. 1988) (court refused to enjoin a poison pill because bidding for the target was proceeding and an order of redemption was premature).

11. *Time, Inc. v. Paramount Communications, Inc.*, [Current Transfer Binder] *Fed. Sec. L.Rep.* (CCH) ¶ 94,514 (Del.Ch. 1989).

12. *Literary Partners, L.P. v. Time, Inc.*, Civ. Action Nos. 10866, 10670 and 10935 (Del.Sup.Ct. 1989). The court affirmed the decision below and said that a formal opinion "will follow in due course."

13. If the court had held that *Unocal* did not apply, Time directors would have prevailed by simply showing that they acted rationally and in good faith—the standard under the business judgment rule. See, *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) for a statement of the business judgment rule in Delaware.

14. *Time, Inc.*, *supra*, note 10 at 93,284.

15. Compare, *Shamrock Holdings, supra*, note 6 at ¶ 94,176 (ESOP was part of long-term planning) with, *Robert M. Bass Group, supra*, note 9 (restructuring was reactive to tender offer).

16. Compare, *Grand Metropolitan PLC, supra*, note 9 (poison pill prohibited offer from closing) with, *The Henley Group, Inc. v. Santa Fe Southern Pacific Corp.*, Civ. Action

No. 9569 (Del.Ch. 1988) (restrictions in proposed debentures did not preclude all takeovers, only those highly leveraged).

17. *Time, Inc.*, *supra*, note 11 at 93,280.

18. [Current Transfer Binder] *Fed. Sec. L.Rep.* (CCH) ¶ 94,401 (Del. 1989).

19. *Id.* at 92,601.

20. *Id.*

IN MEMORIAM

Jack Westley "Jeff" Karford II passed away on November 22, 1989, at the age of 33. A 1984 graduate of DU Law School, Karford practiced with the law firms of Calkins, Kramer, Grimshaw & Haring and Krendl & Krendl before opening his own law office in Englewood in 1987. He was noted for his humor and congenial manner in the courtroom and for his selfless attitude in relationships with others. Karford's friends have established an educational trust fund for his four children. Contributions can be sent to: Mountain Valley National Bank, P.O. Box 339, Conifer, CO 80433, Attn: Karford Children Educational Fund.



Andrew Wysowatcky, one-time public administrator for the City of Denver, died October 19 in Berthoud. He was 88. After graduation from the Westminster School of Law in 1944 and service in the Marine Corps, Wysowatcky went into private practice, then served with the Denver district attorney's office. He was named Denver's public administrator in 1951 and remained in that office until 1974, when he returned to private practice. He retired in 1981.

Former Colorado attorney and District Judge Dean Johnson passed away November 8 in Tucson, Arizona. A 1936 graduate of DU Law School, Johnson worked with several law firms before moving into private practice in 1948. He served as a District Judge from 1970 until his retirement in 1986. Contributions may be made to the Lions Club for the Blind.

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