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Thinking inside the Box: Analyzing Judicial Scrutiny of Deal Protection Devices in Delaware

Thanos Panagopoulos

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Thinking Inside The Box: Analyzing Judicial Scrutiny of Deal Protection Devices in Delaware

Thanos Panagopoulos†

TABLE OF CONTENTS

I. Introduction .................................................................................................. 439

II. Thesis ........................................................................................................ 441

III. What Are Deal Protection Devices? ......................................................... 443
   A. Deal Protection Devices in General ...................................................... 443
   B. The Rationale behind Deal Protection Devices .................................... 443
   C. Specific Deal Protection Devices ......................................................... 444
      1. Termination Fees .............................................................................. 444
      2. Asset Option Agreements ................................................................. 445
      3. No-solicitation Provisions ................................................................. 445
      4. Section 251(c) Provisions ................................................................. 446
      5. Stockholder Voting Agreements ....................................................... 447
   D. Fiduciary Outs ..................................................................................... 447

IV. What Is the Law in Delaware Regarding Deal Protection Devices? ........ 448
   A. Judicial Scrutiny of Corporate Decision Making ............................... 448
   B. Enhanced Scrutiny Under Revlon .................................................... 449
   C. Enhanced Scrutiny Under Unocal ....................................................... 451
   D. Enhanced Scrutiny Applied to Specific Deal Protection Devices ... 453
      1. Termination Fees .............................................................................. 454
         a. In the Change of Control Context; Applying the
            Revlon / Macmillan Ex Post Approach ........................................ 454
         b. In the Change of Control Context; Applying the
            QVC Ex Ante Approach ............................................................... 454
         c. In the Non-Change of Control Context ....................................... 454
      2. Asset Option Agreements ................................................................. 456
         a. In the Change of Control Context; Applying the
            Revlon / Macmillan Ex Post Approach ........................................ 456
         b. In the Change of Control Context; Applying the
            QVC Ex Ante Approach ............................................................... 456
         c. In the Non-Change of Control Context ....................................... 457

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3. No-Solicitation Provisions ............................................................... 457
   a. In the Change of Control Context; Applying the
      Revlon / Macmillan Ex Post Approach or the
      QVC Ex Ante Approach ................................................. 457
   b. In the Non-Change of Control Context .......................... 459

4. Section 251(c) Provisions ............................................................ 460
   a. In the Change of Control Context; Applying the
      Revlon / Macmillan Ex Post Approach or the
      QVC Ex Ante Approach ................................................. 460
   b. In the Non-Change of Control Context ......................... 460

5. Stockholder Voting Agreements .................................................... 461

V. What Is Wrong with the Law in Delaware Regarding Deal Protection

A. The Delaware Supreme Court Should Expressly Commit to the
   Ex Ante Approach Articulated in QVC .................................... 462

B. The Delaware Supreme Court Should Validate the Use of
   Absolute Lock-ups in Appropriate Circumstances ................. 465
   1. The Delaware Supreme Court Erred in Omnicare ............. 466
   2. There is an Alternative Basis to Support the Holding in
      Omnicare ................................................................. 468

3. Per Se Invalidation on the Basis of the Board’s Duty to Act
   in the Best Interests of the Stockholders Relies upon a
   Determination that Delaware Courts Are Uns suited to
   Make .................................................................................. 469

4. Delaware Courts Should Recognize that Under Certain
   Circumstances, Agreeing to an Absolute Lock-up is
   Consistent with the Board’s Fiduciary Duty to Manage the
   Corporation in the Best Interests of its Stockholders .......... 470

C. The Delaware Supreme Court Should Reverse Omnicare ......... 471

VI. Conclusion .................................................................................. 473
Judicial Scrutiny of Deal Protection Devices in Delaware

Thinking Inside The Box: Analyzing Judicial Scrutiny of Deal Protection Devices in Delaware

Thanos Panagopoulos

I. INTRODUCTION

When an acquiring company negotiates a merger with a target company, there is an asymmetry of information concerning the target company's commitment to consummating the deal. To compensate for the risk that the target company will choose not to consummate the deal after the acquiring company has invested time and capital into negotiating the transaction and incurred an opportunity cost, an acquiring company will discount the price it is willing to pay to acquire the target company. 1 If the transaction is consummated, target stockholders receive less for their stock than the acquiring company would have been willing to pay absent the risk of non-consummation. If the information asymmetry, that is, the perceived risk of non-consummation, is sufficiently high such that the acquiring company has discounted the price it is willing to pay below a level that is acceptable to the target company, the transaction simply does not occur and the target stockholders lose the opportunity to sell their stock. 2

In order to reduce the risk that the target company will not consummate the deal, dealmakers commonly use contractual provisions known as “deal protection devices.” These either prohibit the target board from taking a specified action that the acquiring company deems to be adverse to consummating the deal, or impose a penalty for doing so. By reducing the risk of non-consummation, deal protection devices reduce the discount that the acquiring company would otherwise apply to the price it is willing to pay to acquire the target company. 3 Thus, the acquiring company is willing to pay more, in some cases facilitating transactions that otherwise would not occur. 4 As such, the use of deal protection devices creates value both for the acquiring company’s stockholders, by reducing the risk of non-consummation, and for the target company’s stockholders, by securing the opportunity to sell their stock at a higher price.


2. Id.

3. Id.

4. Id.
However, this value is created at a potential cost to the target company. Reducing the risk of non-consummation comes at the expense of restricting the target company’s ability to negotiate other transactions. Thus, by reducing the risk of non-consummation, deal protection devices increase the risk that the target company will forego a more valuable transaction. Therefore, deal protection devices only create value for target company stockholders when the deal they protect is the most valuable transaction available to the target company.

The fact that the parties agreeing to a corporate transaction are not the owners of the underlying assets, but are the owners’ agents, complicates the value of deal protection devices. Under Delaware law, the directors of a corporation are in charge of managing its affairs, including the negotiation of corporate mergers for the benefit of the corporation’s stockholders. This agency relationship makes directors fiduciaries of the corporation’s stockholders subject to duties of care and loyalty.

However, directors are often beholden to management because of management’s role in nominating the slate of directors to be voted on by stockholders and in providing directors with auxiliary compensation through consulting fees and sales contracts. Management, in turn, has a vested interest in continued employment and its own compensation. Thus, to the extent that directors can negotiate a transaction that retains the company’s management or compensates them generously, they have an incentive to do so. Achieving this objective comes at the expense of stockholders when it involves approving a less valuable transaction solely for that purpose. Deal protection devices can be used to protect a deal that benefits managers and directors at the expense of stockholders by restricting the target company’s ability to negotiate a more valuable transaction with another party.

Accordingly, Delaware courts have recognized that approval of deal protection devices involves issues of corporate control, and “where issues of corporate control are at stake, there exists the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.” On that basis, Delaware courts scrutinize director

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5. Why Delaware? In short, this paper focuses upon Delaware corporate law because “[fully 60 percent of Fortune 500 companies are incorporated in Delaware.” Stephen Bainbridge, Delaware’s Dominance, Jan. 22, 2004, http://www.professorbainbridge.com/2004/01/delawares_domin.html. As a result, in order to do deals with public companies, most practitioners cope with the law of Delaware more than the law of any other state. Not surprisingly, the Delaware judiciary has become the foremost authority on corporate law in the United States.

6. Directors are in charge of negotiating the terms of a corporate merger, but actual consummation remains subject to the final approval of the corporation’s stockholders.


8. See Macmillan, 559 A.2d at 1280; see also Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).

9. Macmillan, 559 A.2d at 1287 (paraphrasing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946,
approval of deal protection devices much more closely than the directors’ day-
to-day management of the corporation. In cases in which approval of deal
protection devices conflicts with directors’ fiduciary duties, Delaware courts
have invalidated them.\textsuperscript{10}

Unfortunately, certain Delaware rulings have also effectively restricted
board approval of deal protection devices in situations in which such approval
arguably does not conflict with directors’ fiduciary duties to stockholders.\textsuperscript{11}
These rulings sacrifice the value added by deal protection devices in order to
allow stockholders the freedom to consider superior offers despite the fact that
they are unlikely to emerge. Thus, these rulings prevent the use of deal
protection devices even when the deal they would protect is likely to be the
most valuable transaction available to the target company’s stockholders.

\textbf{II. THESIS}

In a line of cases beginning with \textit{Unocal} and culminating in \textit{Omnicare}, the
Delaware courts have issued a series of rulings limiting the use of deal
protection devices. Delaware precedent in this area principally suffers from two
shortcomings. First, the Delaware Supreme Court has yet to demonstrate a
proven commitment to analyzing a target board’s decision to agree to deal
protection devices from an \textit{ex ante} perspective, that is, evaluating the
reasonableness of the board’s decision at the time it was made rather than in
light of subsequent events. Second, the Delaware Supreme Court has ruled that
absolute lock-ups are \textit{per se} invalid. This is because they limit a target board’s
ability to exercise its fiduciary duties by purporting to require the board to
refrain from action that may be required by those duties. Both an \textit{ex post}
approach to enhanced scrutiny and \textit{per se} invalidation of absolute lock-ups
limit a board’s ability to discharge its fiduciary duty to act in stockholders’ best
interests and usurp the proper role of the board of directors.

A board’s fiduciary duty is to act in the stockholders’ best interests. In
certain circumstances, deal protection devices create the most value available
for target company stockholders by securing the opportunity to sell their stock
at the highest price available. Where a board reasonably determines that those
circumstances are present, its decision to agree to deal protection devices is
consistent with its duty to act in the stockholders’ best interests and should not
be invalidated merely because subsequent events cast doubt on the board’s

\textsuperscript{954} (Del. 1985)).
\textsuperscript{10. See, e.g., \textit{Revlon}, 506 A.2d at 173; \textit{Macmillan}, 559 A.2d at 1261; \textit{Paramount Commc’ns, Inc. v.
QVC Network Inc.}, 637 A.2d 34 (Del. 1993).
\textsuperscript{11. This paper will argue that the Delaware Supreme Court’s decisions in \textit{Revlon}, \textit{Macmillan}, and
\textit{Omnicare, Inc. v. NCS Healthcare, Inc.}, 818 A.2d 914 (Del. 2003), effectively disable a target board
from rationally approving deal protection devices because of potential exposure to liability even when
the board reasonably believes they will create value for stockholders.}
determination. However, in the absence of a proven judicial commitment to an ex ante approach to enhanced scrutiny, dealmakers cannot confidently use deal protection devices of any kind to secure and improve the value of transactions that will result in a change of control, no matter what the circumstances, because of the risk of invalidation should a superior offer subsequently emerge. Thus, an ex post approach restricts a board’s ability to agree to deal protection devices even when the board reasonably determines that such action is probably in the stockholders’ best interests.

Even in the non-change of control context, dealmakers cannot agree to absolute lock-ups because they are per se invalid in Delaware as a result of the Delaware Supreme Court’s decision in *Omnicare.* Thus, regardless of the court’s approach to enhanced scrutiny, a board cannot agree to an absolute lock-up even when it reasonably determines that such action is probably in the stockholders’ best interests.

By taking an ex post approach, and ruling absolute lock-ups per se invalid, the Delaware Supreme Court has enforced a substantive conclusion that deal protection devices in the change of control context, and absolute lock-ups in any context, are not in the best interests of stockholders because they destroy more value than they create. However, intuition dictates that a reasonable determination by a board of directors is more often right than wrong. Otherwise, the long-standing dominance and success of director-managed commercial entities would be difficult to explain. If a board’s reasonable determination is more often right than wrong, then its decision to agree to deal protection devices after reasonably determining that a superior offer neither exists nor is likely to emerge is more likely to create value for stockholders than to thwart a superior offer. Determination of whether the value created exceeds on average the value lost when, despite the board’s reasonable decision-making process, deal protection devices do in fact thwart superior offers, requires an econometric analysis that courts are ill-suited to undertake. Therefore, the responsibility for making this determination is properly left to the board of directors, subject to enhanced scrutiny of its decision-making process.

Accordingly, the Delaware Supreme Court should: (1) expressly commit to the ex ante approach to enhanced scrutiny as articulated in *QVC* at the next available opportunity; (2) validate the use of absolute lock-ups in appropriate circumstances by recognizing that where a target company’s disinterested board of directors has adequately canvassed the market and negotiated with available bidders in a competitive environment to reasonably determine that a superior offer neither exists nor is likely to emerge, a decision to agree to contractual provisions that limit the board’s ability to negotiate other offers is

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Judicial Scrutiny of Deal Protection Devices in Delaware

consistent with the board’s fiduciary duty to manage the corporation in the best interests of its stockholders; and (3) reverse Omnicare in line with this proposed recognition.

III. WHAT ARE DEAL PROTECTION DEVICES?

A. Deal Protection Devices in General

Deal protection devices are contractual terms that serve to motivate the subject party to consummate the underlying transaction. Although these devices may bind the acquiring company as well as the target company, for reasons explained below, only their effect upon the target company is relevant here.

Similar to financial products, the number of forms that deal protection devices can take is limited only by the imaginations of the dealmakers that use them. However, an exhaustive list of the deal protection devices currently used in corporate transactions is neither helpful, nor particularly necessary, because the principles of Delaware law applicable to deal protection in general were developed through judicial scrutiny of a finite number of specific devices that resulted in precedent. This article will limit the scope of its examination to those specific deal protection devices, which include termination fees, asset option agreements, no-solicitation provisions, section 251 provisions, and stockholder voting agreements. Each of these devices incentivizes the subject party in a specific way, and more often than not, dealmakers use more than one type in combination.

B. The Rationale behind Deal Protection Devices

In order to understand how these devices work, it is important to understand why dealmakers use them in the first place. Negotiating a corporate merger requires considerable expense of time and money by both parties. In that sense, both parties have a strong incentive to complete the merger once they have invested the necessary resources. However, the target company often has an incentive to walk away from the transaction if it can use the acquiring company as a “stalking horse.” In this scenario, the acquiring company’s bid for the target company becomes both a signal to the market that the target company is a valuable acquisition as well as a benchmark of that value. This signal draws other potential acquirors into offering superior bids, often resulting in a bidding war that profits the target company handsomely at the expense of the initial acquiring company’s investment of resources.

The acquiring company does not usually have a similar incentive. Suffice it to say that when a merger agreement is announced, rival companies are rarely seen attempting to outbid the target company by offering themselves for a lower price. This is one of two reasons that only the effect of deal protection
devices on the target company is treated here. The other reason involves the heightened judicial scrutiny that target companies receive when negotiating a corporate merger in comparison with acquiring companies. The courts are generally concerned with protecting stockholders from losing an opportunity to receive a control premium for their shares due to the decision-making process of the board. Because this is a risk unique to the target company, only a target board’s decision to agree to a deal protection device is subject to enhanced scrutiny and thus possible invalidation.\textsuperscript{13}

Where the target company is committed to the transaction because it believes that it offers the most value available, the risk that the acquiring company will walk unless the target company accedes to its demands for deal protection devices constitutes a significant potential cost. Furthermore, even if the acquiring company chooses to engage in negotiations with the target company free of deal protection devices, the acquiring company will discount its acquisition offer to reflect its uncertainty concerning the target company’s commitment.\textsuperscript{14} Put differently, because of the time and expense involved in negotiating an acquisition, the acquiring company will pay a premium for the increased certainty that the transaction will be consummated that is achieved by the target company’s accession to deal protection devices.

Thus, an acquiring company demands deal protection devices to defend against the risk that the target company will either use the acquiring company as a “stalking horse,” or simply get cold feet and walk. If the target company is committed to a transaction with the acquiring company, then it accedes to those demands because deal protection devices can secure and increase the value of the transaction by decreasing the information asymmetry as to its level of commitment.

\textbf{C. Specific Deal Protection Devices}

\textit{1. Termination Fees}

A termination fee is a contractual provision that requires the target company to pay a fee to the acquiring company if the target company chooses to terminate the agreement in a manner that is specified in the provision.\textsuperscript{15}

\textsuperscript{13} While an acquiring company’s decision to adopt a deal protection device that was mutually binding could be challenged, the board’s decision would be entitled to the protection of the business judgment rule under which the board’s decision would not be invalidated as long as the court could find any rational basis to support it. It is difficult to imagine a realistic hypothetical in which a rational basis could not be found for an acquiring company’s decision to adopt a mutually binding deal protection device. Furthermore, the vast majority of deal protection devices bind only the target company for the simple reason noted above: that few if any bidding wars have ever occurred between companies vying to be targets of an acquiring company.

\textsuperscript{14} The propositions presented in this paper assume that the parties are rational actors.

\textsuperscript{15} Dennis J. Block, \textit{Public Company M&A: Recent Developments in Corporate Control},
Triggers may include, *inter alia*, lapse of a specified date without consummation of the underlying transaction, express termination of the agreement, the target board's failure to submit the merger to its shareholders, the target board's failure to recommend the merger to its shareholders, the target company's consummation of a merger with another company in lieu of the acquiring company, or any combination of the above.\(^6\)

A termination fee has three effects which are beneficial from the acquiring company's standpoint: (1) it incentivizes the target company to consummate the merger in order to avoid incurring the fee; (2) it provides a deterrent to rival bidders by making it more expensive to outbid the acquiring company; and (3) it compensates the acquiring company for the expense of negotiating the underlying agreement.

2. **Asset Option Agreements**

Colloquially referred to as a "lock-up,"\(^17\) an asset option agreement provides the acquiring company the right to purchase specified assets of the target company at a stated price.\(^8\) The strike price is generally set at a deep discount from the assets' market value in order to make the target company less attractive to rival bidders by decreasing the value of its assets. Alternatively, the option can be to purchase a key asset of the target company, which makes it less attractive to rival bidders regardless of whether the strike price is set at a discount to the asset's market value. This is colloquially referred to as a "crown jewel lock-up."\(^19\) From the standpoint of the acquiring company, the effects of an asset option agreement are substantially the same as the effects of a termination fee described above.

3. **No-solicitation Provisions**

No-solicitation provisions include terms that vary widely from agreement to agreement but generally can be divided into two major varieties: "no-shop" provisions and "no-talk" provisions. A no-shop provision prohibits the target company from actively soliciting other potential acquirors but allows the target company to negotiate with a third-party which makes an unsolicited offer to

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\(^6\) Protective Mechanisms and Other Deal Protection Devices, in CONTESTS FOR CORPORATE CONTROL 2006, at 7, 97 (PLI Corp. L. & Practice, Course Handbook Series No. 1528, 2006); see, e.g., QVC, 637 A.2d at 39.

\(^16\) Block, supra note 15, at 103-04.


\(^19\) A crown jewel is commonly defined as the most valuable unit of a corporation for reasons such as profitability, asset value, future prospects, etc. See, e.g., Macmillan, 559 A.2d at 1286.
acquire the target company.\textsuperscript{20} A no-shop provision may require that the unsolicited offer meet certain specified terms, such as that the terms of the third-party’s offer be superior to the terms of the original acquiring company’s offer.\textsuperscript{21} A no-shop provision prohibits the target company from actively marketing itself in order to spark a bidding war between potential acquirors but leaves the target company’s board the flexibility to consider unsolicited offers in order to discharge its fiduciary duty to the target company’s stockholders.

A no-talk provision prohibits the target company not only from actively soliciting other potential acquirors but also from negotiating with or even furnishing information to a third-party which has made an unsolicited offer to acquire the target company, regardless of the terms of the offer.\textsuperscript{22} A no-talk provision can be severely restrictive because in the event that the target board subsequently begins to doubt whether the transaction is in the best interests of the stockholders, the inability to consider alternatives complicates a decision to terminate.

Without considering alternatives the board cannot easily determine whether a superior alternative is available. Even if another company has expressed its willingness to acquire the target company on more favorable terms, the legitimacy and legality of its offer cannot be determined by the target board without negotiations that are prohibited by a no-talk provision. Terminating an existing transaction without confirming that a superior alternative is available could subject the board to liability for failure to maximize stockholder value should a superior alternative fail to materialize. Under such circumstances, the target company could be left with no transaction at all.

Particularly where the target company is in a difficult financial position, the potential to be left without an acquiror operates as a powerful incentive to recommend an existing transaction to the stockholders even if the target board believes more favorable alternatives may exist. Target stockholders are likely to approve the transaction in the absence of information concerning alternatives. Thus, the use of a no-talk provision can be harmful to target company stockholders because it significantly increases the likelihood that the underlying transaction will be consummated even when it is actually inferior to available alternatives.

\textbf{4. Section 251(c) Provisions}

Pursuant to Delaware General Corporation Law (hereafter “DGCL”) section 251(c), a corporation’s board of directors can agree to submit a merger
proposition to a stockholder vote even if they no longer recommend the merger.\textsuperscript{23} A section 251(c) provision is a contractual provision that requires the target company's board of directors to do so.\textsuperscript{24} Although a section 251(c) provision guarantees that the target company's stockholders will consider the transaction, it is not particularly powerful in isolation because the target board may still choose not to recommend the merger proposal, which the stockholders are likely to take into account when voting. However, as explained below, in combination with stockholder voting agreements, a section 251(c) provision can create what is known as an "absolute lock-up."\textsuperscript{25}

5. Stockholder Voting Agreements

A stockholder voting agreement is a contract between the acquiring company and stockholders of the target company under which the stockholders agree in advance to vote to approve the merger between the acquiring company and the target company.\textsuperscript{26} The target board is not a party to a stockholder voting agreement; therefore, while a stockholder voting agreement binding stockholders with a controlling interest in the target company ensures that the transaction will be consummated if put to a stockholder vote, the target board may still choose not to submit the transaction to the stockholders. However, when stockholder voting agreements binding stockholders who own a controlling interest in the target company are combined with a section 251(c) provision, the combination of deal protection devices operates as an "absolute lock-up": the section 251(c) provision requires the target board to submit the transaction to a vote of stockholders that is predetermined by the stockholder voting agreements thus guaranteeing consummation of the transaction as soon as the merger agreement is signed by the target board.

D. Fiduciary Outs

A "fiduciary out" is a contractual provision that allows the target board to take action prohibited by an underlying deal protection device in the event that the target board determines that such action is required to fulfill its fiduciary duties.\textsuperscript{28} A fiduciary out generally defeats the purpose of the underlying deal protection device because deal protection devices are intended to operate in precisely the circumstances that implicate a target board's fiduciary duties,

\textsuperscript{23} \textit{Del. Code Ann. tit. 8, § 251(c) (2005).}
\textsuperscript{24} \textit{See, e.g., Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 918 (Del. 2003).}
\textsuperscript{25} \textit{Omnicare, 818 A.2d at 926.}
\textsuperscript{26} \textit{Block, supra note 15, at 111; see \textit{e.g., Omnicare, 818 A.2d at 938; ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 96 (Del. Ch. 1999).}
\textsuperscript{27} \textit{Omnicare, 818 A.2d at 934-38.}
\textsuperscript{28} \textit{Block, supra note 15, at 89.}
namely when a superior alternative offer emerges. If that were not the case, there would be little need for deal protection devices. An acquiring company has little reason to fear that a target board will choose not to consummate a transaction because of a less valuable alternative. Therefore, including a fiduciary out is the practical equivalent of invalidating a deal protection device.

IV. WHAT IS THE LAW IN DELAWARE REGARDING DEAL PROTECTION DEVICES?

Delaware courts do not determine the validity of deal protection devices in a vacuum. The legal standard applied to a board's decision to agree to deal protection devices depends upon the legal standard applied to the board of directors' approval or rejection of the underlying transaction. Therefore, an analysis of Delaware's treatment of deal protection devices also requires an understanding of the legal framework within which its courts scrutinize the transactions that underlie them. The following sections summarize Delaware law concerning a board's decision to approve a deal and the effect this has on a board's decision to agree to devices to protect that deal.

A. Judicial Scrutiny of Corporate Decision Making

Pursuant to DGCL section 141(a), the ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors. In discharging this function the directors owe fiduciary duties of care and loyalty to the corporation and its stockholders. These principles apply with equal force when a board approves a corporate merger pursuant to DGCL section 251(b). If the business judgment rule applies, there is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.

However, "where issues of corporate control are at stake," as in a merger, "there exists the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders." For that reason, the board's decision must satisfy enhanced scrutiny by the court before the board receives the normal protections of the business judgment rule.

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29. DEL. CODE ANN. tit. 8, § 141(a) (2005).
30. Id. § 251(b).
33. Id.
Judicial Scrutiny of Deal Protection Devices in Delaware

B. Enhanced Scrutiny Under Revlon

Enhanced scrutiny is applied differently depending on what issues of corporate control are raised by the directors’ decisions. In Revlon, the Delaware Supreme Court held that in certain circumstances, enhanced scrutiny requires the court to examine whether directors of a corporation have “[acted] reasonably to seek the transaction offering the best value reasonably available to the stockholders.”34 This duty applies in at least the following three scenarios: (1) when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company; (2) where, in response to a bidder’s offer, a target abandons its long-term strategy and instead seeks an alternative transaction involving the break-up of the company; or (3) when approval of a transaction results in a sale or change of control.35 When negotiating a transaction that invokes enhanced scrutiny under Revlon, a board must canvas the market if it has no reliable grounds upon which to judge the transaction’s adequacy.36 Accordingly, in a transaction that invokes enhanced scrutiny under Revlon, a board’s decision to adopt deal protection devices must comport with the directors’ duty to act reasonably to seek the transaction offering the best value reasonably available to the stockholders.

In both Revlon and Macmillan, the Delaware Supreme Court articulated a decidedly ex post approach to applying this form of enhanced scrutiny by focusing on the actual effect that the deal protection devices in question had upon the stockholders rather than the reasonableness of the board’s decision to agree to those deal protection devices at the time it was made.37 Under this

34. Paramount Commc’ns, Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1993); see also Revlon, 506 A.2d at 182; Macmillan, 559 A.2d at 1288.
37. In Revlon, the court invalidated the Revlon board’s decision to agree to a white knight strategy that included a lock-up, stating that “while those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders’ detriment.” Revlon, 506 A.2d at 183. The court also noted that the result of the lock-up in question was not to foster bidding, but to destroy it, and that “the Revlon board ended the auction in return for very little actual improvement in the final bid . . . to the ultimate detriment of its shareholders.” Id. By focusing on the result of the lock-up rather than what the Revlon board knew at the time it agreed to the lock-up, this language suggests that the validity of a lock-up is judged ex post. However, the same lock-up which draws a bidder into a contest for control of the target company can end that very auction and foreclose further bidding if the hostile bidder increases its offer to within a range foreclosed by the lock-up. A target board cannot determine ex ante what the hostile bidders’ response will be. If the hostile bidder fails to increase its offer, the target board’s accession to the lock-up survives enhanced scrutiny because it secures a more valuable transaction for the stockholders. However, if on the very same facts, the hostile bidder chooses to increase its bid to within a range foreclosed by the lock-up, the court’s ex post approach suggests that the board’s decision to agree to a lock-up will be invalidated as a breach of fiduciary duties under Revlon. Thus, the holding in Revlon forces a target board to forego the use of a lock-up in order to avoid risking a violation of its fiduciary duties.

In Macmillan, the court stated that the trial court must first examine whether the directors properly
approach, a target board’s decision to agree to virtually any type of deal protection device, no matter how reasonable, is invalid if it subsequently prevents stockholders from considering a superior offer. Because a board cannot predict in advance whether or not a superior offer will emerge, an ex post approach effectively invalidates most deal protection devices in transactions subject to enhanced scrutiny under Revlon.\(^{38}\)

However, in \textit{QVC}, the court articulated enhanced scrutiny differently. It held that the key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decision-making process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors’ action in light of the circumstances then existing.\(^{39}\) The directors have the burden of proving that they were adequately informed and acted reasonably.\(^{40}\) However, a court applying enhanced judicial scrutiny must decide whether the directors made a reasonable decision, not a perfect decision.\(^{41}\) If a board selected one of several reasonable alternatives, a court will not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board’s determination.\(^{42}\)

This ex ante perspective suggests that where a target board can reasonably determine that no superior offer exists or is likely to emerge, its decision to agree to certain deal protection devices should withstand enhanced scrutiny under Revlon. A board cannot reasonably determine that no superior offer is likely to emerge while competing bidders remain willing to negotiate their offers in good faith because under that circumstance there is a substantial likelihood that superior bids will in fact emerge. However, where the board has adequately canvassed the market, but either the transaction at issue is the only offer available, or all other existing offers are both inferior and no longer negotiable, a determination that the value to be obtained by agreeing to deal protection devices outweighs the unlikely risk of losing a superior transaction would be reasonable because the target board has already made an adequate but perceived that stockholder interests were enhanced. \textit{Macmillan}, 559 A.2d at 1288. In other words, the trial court must examine whether this is the result of the board’s action rather than its decision-making process. The court also held that the grant of an auction-ending provision must confer a substantial benefit upon the stockholders in order to withstand exacting scrutiny by the courts. \textit{Id.} at 1284. This logic presents the board of a target company with the same Hobson’s choice (see infra note 98) that the logic in Revlon presents because a board cannot determine ex ante whether a deal protection device will confer a substantial benefit upon the stockholders. There is always the possibility that the hostile bidder will increase its offer after the deal protection devices are agreed to.

\(^{38}\) As discussed below, a termination fee or asset option agreement of a size so small that it has no tendency to make the target company less attractive to other bidders should survive enhanced scrutiny even under an ex post approach.

\(^{39}\) \textit{QVC}, 637 A.2d at 45.

\(^{40}\) \textit{Id.}

\(^{41}\) \textit{Id.}

\(^{42}\) \textit{Id.}
unsuccessful effort to attract an active bidding contest. Such a determination should be granted deference by the courts regardless of subsequent events such as the actual emergence of a superior offer. Where the board reasonably determines that a superior offer is unlikely to emerge, there is little justification for depriving stockholders of the value created by deal protection devices.

However, the Delaware Supreme Court's commitment to the ex ante approach required by QVC remains untested. QVC presented a factual scenario in which the board's decision was unreasonable both at the time it was made, as well as in light of subsequent events. As a result, QVC did not provide a proper test of how the court would respond to a situation in which the target board made a reasonable decision to adopt deal protection devices in a transaction that would result in a change of control, but a superior offer unexpectedly emerged and the deal protection devices precluded the board from considering that offer. The court has yet to hear such a case.

C. Enhanced Scrutiny Under Unocal

A transaction does not invoke enhanced scrutiny under Revlon when the consideration received by the target company's stockholders consists of stock in a public corporation that is not subject to a controlling stockholder interest, because control of the target corporation remains in a large, fluid, changeable and changing market. This result can be achieved using a stock-for-stock merger (hereafter referred to as a "qualifying stock-for-stock merger"). A board's decision to approve a qualifying stock-for-stock merger does not invoke enhanced scrutiny and is therefore entitled to the protection of the business judgment rule.

In the context of a qualifying stock-for-stock merger, a board's decision to adopt deal protection devices is treated as a decision to adopt a defensive

43. Paramount had executed a merger agreement with Viacom that contained several defensive provisions, including among others, a no-shop provision, a termination fee, and a stock option agreement. QVC, 637 A.2d at 39. QVC subsequently submitted a competing offer to acquire Paramount. Id. Paramount renegotiated its agreement with Viacom to be more competitive but retained the deal protection devices. Id. at 40. Paramount's board contended that the no-shop provision barred it from negotiating with QVC. Id. at 41. In addition, the value of the combined termination fee and stock option agreement imposed an economic barrier to QVC's bid. Id. at 51. QVC brought suit and the court invalidated the deal protection devices. Id. at 57. Paramount's decision not to renegotiate these deal protection devices when its agreement with Viacom was renegotiated, despite QVC's consistently demonstrated intent to meet and exceed Viacom's offers was unreasonable from an ex post perspective because it prevented Paramount's stockholders from considering QVC's superior offer. However, Paramount's decision was also unreasonable even from an ex ante perspective because its board knew that QVC was likely to make a superior offer at the time it chose to leave the deal protection devices with Viacom in place.


46. Id.
measure to defend against a perceived threat to corporate policy and effectiveness which touches upon issues of control. Such decisions are subject to enhanced scrutiny as articulated in Unocal.

First, the board's decision must pass a "reasonableness test," which requires a demonstration that the board had reasonable grounds for believing that a danger to corporate policy and effectiveness existed. The board must show that, after a reasonable investigation, it determined in good faith that the threat warranted a defensive response. The presence of a majority of outside independent directors materially enhances such evidence. Legally cognizable threats include both the economic inadequacy of the offer and substantive coercion, that is, the risk that stockholders will mistakenly accept an under-priced offer because they disbelieve management's representations of intrinsic value.

Second, the board's decision must pass a "proportionality test," which requires a showing that the board of directors' defensive response was reasonable in relation to the threat posed. In order to be reasonable in relation to the threat posed, the response must not have been draconian, which the court has defined as either coercive or preclusive. A coercive response aims at forcing upon stockholders a management-sponsored alternative to a hostile offer by "causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction." A preclusive response "deprives stockholders of the right to receive all tender offers or precludes a bidder from seeking control by fundamentally restricting proxy contests or otherwise."

If a defensive measure is not draconian, the focus of enhanced judicial scrutiny then shifts to the range of reasonableness. The ratio decidendi for the "range of reasonableness" standard is a need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its stockholders when defending against perceived threats. If the board of directors' defensive response is not draconian and is within a range of reasonableness, a court will not substitute its judgment for the judgment of the

50. Id. at 1375.
51. Id.
52. Id. at 1384.
53. Id. at 1373.
54. Id. at 1375.
56. Id.
57. Unitrin, 651 A.2d at 1387-88.
Judicial Scrutiny of Deal Protection Devices in Delaware

The *ratio decidendi* for the "range of reasonableness" standard is on its face somewhat ambiguous. What does it mean to allow the board latitude in discharging its fiduciary duties? If this condition is merely read as a prohibition against defensive measures which violate the board’s fiduciary duties to the corporation, then the analysis becomes circular because the *Unocal* test itself is designed to determine whether a defensive measure violates those duties. Therefore, this condition is best read to require that the defensive measure allow the board to discharge its fiduciary duties on an ongoing basis. Because properly pleaded allegations of a breach of the board’s duty of loyalty would invoke scrutiny of entire fairness, the condition can be further refined to refer solely to the board’s duty of care.

The Delaware Supreme Court has also articulated this requirement outside of the context of enhanced scrutiny. The court has drawn from the *Restatement (Second) of Contracts* section 193 to hold that "to the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable." The court has used this principle to invalidate deal protection devices and other defensive measures.

Pursuant to *Time*, a target board can validly agree to deal protection devices to maximize the value of a qualifying stock-for-stock merger even in the face of a hostile offer of a higher face value, as long as there is a basis to sustain its preference. That basis is not limited to a discounted value of the company’s expected trading price at some future date that is higher than the present value of the hostile offer because the board may consider the timing of the offer, questions of illegality, the impact on constituencies other than stockholders, the risk of non-consummation, and the quality of securities being offered in the exchange.

D. Enhanced Scrutiny Applied to Specific Deal Protection Devices

The Delaware Supreme Court’s articulation of enhanced scrutiny under *Revlon* and *Unocal* impacts the valid use of specific deal protection devices as follows:

58. *Id.* at 1388.
60. *QVC*, 637 A.2d at 51; *Omnicare*, 818 A.2d at 936.
62. *Id.* at 1153.
1. Termination Fees

a. In the Change of Control Context; Applying the Revlon / Macmillan Ex Post Approach

A target board considering whether to agree to a particular termination fee is required, virtually without exception, to apply the test articulated in QVC: whether the termination fee makes the company less attractive to other bidders. A termination fee that passes that test will not prevent consummation of a superior offer should one emerge. Because it is difficult to estimate a ceiling above which a termination fee will make a company less attractive to other bidders, a board applying this test must be wary of agreeing to a termination fee of any substantial size.

b. In the Change of Control Context; Applying the QVC Ex Ante Approach

Where the target company is subject to an active bidding contest, or the board determines that a bidder is likely to emerge, the board must apply the test from QVC noted above. However, under an ex ante approach, a larger termination fee agreed to after a reasonable determination that a superior offer is unlikely to emerge should survive enhanced scrutiny under Revlon as long as it satisfies enhanced scrutiny under Unocal, as applied in the non-change of control context discussed below.

c. In the Non-Change of Control Context

Pursuant to Omnicare, deal protection devices must not "have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction." This requirement prohibits the use of termination fees that are so punitive that they coerce the stockholders into approving the underlying transaction simply in order to avoid the cost incurred by a rejection. Clearly then, there is a limit to the permissible size of a termination fee. However, determining that limit is hardly an exact science.

Pursuant to IXC, there is no magic number which provides an absolute ceiling for permissible termination fees because the reasonableness of a termination fee will be determined in light of all of the terms of the agreement and the fairness of the negotiating process. The Court of Chancery's
comments in *IXC* reflect the fact that courts are not in a good position to make a quantitative determination of whether the size of a given termination fee is unreasonable in proportion to the value of a transaction. Because the value of a particular deal and the cost of adequately compensating the acquiring company for the time and money it has invested are inherently ambiguous determinations, an examination of the reasonableness of the fee itself is likely to devolve into a battle of experts opining on matters outside of the expertise of the court.

The court is much better suited to evaluating the fairness of the negotiating process, which, in light of the aforementioned ambiguity, is probably a good proxy for reasonableness because a fair process should achieve a fair result. Thus, the court would much prefer to defer to the business judgment of the directors concerning the size of the termination fee if it can establish to its own satisfaction that the directors engaged in a fair negotiating process. Therefore, directors can markedly strengthen their position by actively negotiating the termination fee on an informed basis.

Despite the Court of Chancery’s comment in *IXC* that “[i]t is very difficult to say that any termination fee is so excessive on its face that it is unenforceable,”*Id.*, dicta in *Phelps Dodge* that “6.3 percent certainly seems to stretch the definition of range of reasonableness and probably stretches the definition beyond its breaking point”*Phelps Dodge* suggests that dealmakers should tread carefully when negotiating a termination fee over 6%. *In re Pennaco* indicates that termination fees of 3.5% or less are unlikely to be invalidated because their validity is supported by Delaware precedent.

Read together, *QVC* and *IXC* provide that even a reasonable termination fee will be invalidated when used with an asset option agreement if the devices’ combined value has the effect of causing the stockholders to vote in favor of the proposed transaction in order to avoid the cost that would be incurred by a rejection. Thus dealmakers considering both a termination fee and an asset option agreement should consider both the impact of the termination fee itself as well as its impact in combination with the asset option agreement.

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68. *Id.* at *28-29.
69. *Id.*
2. Asset Option Agreements

a. In the Change of Control Context; Applying the Revlon / Macmillan Ex Post Approach

Under an ex post approach the board must defend against the possibility that a superior offer will emerge regardless of the circumstances at the time the agreement is executed. Therefore, the test from QVC—whether the asset option agreement makes the company less attractive to other bidders—provides a substantial limitation on the use of asset option agreements because they are primarily intended for that very purpose.\(^\text{72}\)

b. In the Change of Control Context; Applying the QVC Ex Ante Approach

Where the board has not or cannot reasonably determine that a superior offer is unlikely to emerge, the test from QVC noted above still restricts the use of asset option agreements. However, an asset option agreed to after a reasonable determination that a superior offer is unlikely to emerge should survive enhanced scrutiny under Revlon as long as it satisfies enhanced scrutiny under Unocal, discussed below in the non-change of control context.

Macmillan indicates that crown jewel lock-ups are more suspect and thus require greater care by the board.\(^\text{73}\) Language in Macmillan suggests that a board must first seek alternative offers before using a crown jewel lock-up to end an active bidding contest.\(^\text{74}\) In fact, a board should probably seek alternative offers before granting an asset option agreement of any kind, even absent a bidding contest, in order to establish the reasonableness of its determination that a superior bid is unlikely to emerge. Otherwise, the validity of its decision may not be protected from subsequently occurring events under QVC.

Although Barkan dictates that the board does not need to canvas the market if it possesses a body of reliable evidence with which to evaluate whether a superior offer will emerge,\(^\text{75}\) the board’s decision to adopt an asset option agreement is much easier to defend where the board has canvassed the market rather than relied on another less convincing source of evidence. The Delaware Supreme Court made its opinion of such alternative bases clear by its citation to the Court of Chancery in Barkan: “A decent respect for reality forces one to admit that . . . advice [of an investment banker] is frequently a pale substitute for the dependable information that a canvas of the relevant market can

\(^{72}\) Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 49 (Del. 1994).
\(^{74}\) Id.
\(^{75}\) Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1287 (Del. 1989).
Judicial Scrutiny of Deal Protection Devices in Delaware

provide.” 76

c. In the Non-Change of Control Context

As with termination fees, Unitrin prohibits the use of asset option agreements that are so valuable that they coerce the stockholders into approving the underlying transaction simply in order to avoid the cost that would be incurred by a rejection. 77 Delaware precedent provides no indication as to what size asset option agreement meets this test.

Although the Court of Chancery’s comments in IXC concerned termination fees, 78 it seems reasonable to conclude that like termination fees, the validity of asset option agreements will be evaluated in light of all of the terms of the merger agreement and the fairness of the negotiating process rather than solely in light of the economic value of the asset option agreement itself. Thus, directors should actively negotiate the asset option agreement on an informed basis as well. As noted in regards to termination fees, dealmakers considering a combination of deal protection devices should consider their combined effect because even a reasonable asset option agreement will be invalidated if the combination of devices has the effect of causing the stockholders to vote in favor of the proposed transaction in order to avoid the cost that would be incurred by a rejection.


a. In the Change of Control Context; Applying the Revlon / Macmillan Ex Post Approach or the QVC Ex Ante Approach

In the change of control context, QVC invalidates the use of both no-talk and no-shop provisions once a competing bidder emerges because they limit the target board’s ability to discharge its fiduciary duty to negotiate with competing bidders in order to obtain the maximum value available for the stockholders. 79 This invalidation is based on the principle that “to the extent

76. Id.
79. In QVC, the court held: [No-shop] provisions, whether or not they are presumptively valid in the abstract, may not validly define or limit the directors’ fiduciary duties under Delaware law or prevent . . . directors from carrying out their fiduciary duties under Delaware law. To the extent such provisions are inconsistent with those duties, they are invalid and unenforceable. Paramount Commc’ns Inc. v. QVC Network Inc., 637 A.2d 34, 48 (Del. 1994). The court later reiterated that “[t]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.” Id. at 51. In a footnote, the court commented that no-shop provisions cannot prevent directors from carrying out their fiduciary duties in considering unsolicited bids or in negotiating for the best value reasonably available.

457
that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.” Accordingly, whether or not the board made a reasonable determination that a superior offer is unlikely to emerge is irrelevant because no determination allows the board to contract away its ability to discharge its fiduciary duties. Therefore, regardless as to whether the court applies an ex post or an ex ante approach, no-solicitation provisions will be invalidated if they prevent the board from negotiating with a subsequently emerging bidder. Thus, although language in both Revlon and QVC suggests that a no-shop provision may be valid at an early stage in order to attract a bidder, the possibility of subsequent invalidation defeats any practical use of no-solicitation provisions for this purpose.

In In re Pennaco, the Court of Chancery validated a merger agreement which included a no-shop provision but allowed for an adequate post-agreement market check. However, the lack of a competing bidder for the target company in that case makes the holding a tenuous basis on which to rely. Even after allowing for a post-agreement market check, a no-shop provision which prevents the board from negotiating with a competing bidder will likely be invalidated by the Delaware Supreme Court under Revlon and QVC. Therefore, In re Pennaco does little to validate the use of no-shop provisions in the change of control context.

80. QVC, 637 A.2d at 51.
83. In re Pennaco presented a factual scenario in which the board’s decision to agree to a no-shop provision was challenged without the existence of a competing bidder. Without an actual alternative, it is difficult for plaintiffs to establish irreparable injury if an injunction does not issue, and that the harm they will suffer absent an injunction outweighs the harm to the defendants that will result from the injunction. The court itself noted, that “this court is justifiably reluctant to enjoin a premium-generating transaction when no other option is available.” Id. at 715. As a result, it is difficult to conclude that In re Pennaco could be relied on to validate a no-shop provision that prevented consideration of a competing bid simply because an adequate post-agreement market check was included. If the board determined that the no-shop provision prevented it from negotiating with a bidder which emerged after the market check was completed, the board’s decision to agree to the no-shop would probably still be found to violate the directors’ fiduciary duties under Revlon.

From a practical standpoint, providing an adequate post-agreement market check defeats the purpose of deal protection anyway because it does little to assure the acquiring company that the transaction will be consummated. Delaying consummation of the merger in order to allow for an adequate post-agreement market check also invites competing bids when it is too late for the acquiring company to conserve its resources by withdrawing from the agreement because the investment of time and capital has already been made. Therefore, an acquiring company is unlikely to increase its bid in return for a no-shop provision subject to an adequate post-agreement market check.

84. See Revlon, 506 A.2d at 184; QVC, 637 A.2d at 49.
b. In the Non-Change of Control Context

No case has limited the valid use of a no-shop provision in the context of a transaction that does not result in a change of control. However, consistent with the board’s duty of care, Time requires that the board have some basis for its decision to protect a transaction. Therefore, where directors choose not to canvas the market, the best practice is to establish on the record some basis for their decision to agree to a no-shop provision. Otherwise, if the transaction is consummated and subsequently challenged by stockholders, an uninformed accession to a no-shop provision could be invalidated as a breach of the board’s duty of care.

Similarly, a no-talk provision adopted in the non-change of control context has yet to be invalidated. However, no-talk provisions stand on much shakier ground than no-shop provisions. The holdings in Time, QVC, and Unitrin all suggest that no-talk provisions are fundamentally inconsistent with directors’ fiduciary duties. Furthermore, in Phelps Dodge the Court of Chancery ruled that the plaintiffs had established a reasonable likelihood of success on the merits of their claim that the defendants had breached their duty of care by agreeing to a no-talk provision. This should send a clear signal that directors assume a substantial risk of invalidation when they agree to a no-talk provision.

A more clear-cut issue is the invalidity of a no-talk provision that operates as part of an absolute lock-up. The Court of Chancery managed to avoid ruling definitively on the issue in ACE, but the Delaware Supreme Court’s per se

86. The holding in Time that “[d]irectors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy,” id., implies that a board must have some basis for its decision not to negotiate with a company which proposes an acquisition. Because no-talk provisions prevent the board from establishing any such basis, they are arguably invalidated by Time. For QVC’s invalidation of no-talk provisions, see supra note 56. Unitrin provides two bases on which to invalidate no-talk provisions. The first is the requirement that defensive measures must not be coercive, that is, should not “have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction.” Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 945 (Del. 2003). This could be used to prohibit the use of no-talk provisions because they may result in stockholders voting to approve a transaction without the benefit of information concerning the existence or absence of an alternative transaction that would have been available had the board been able to consider unsolicited offers. The merits of a transaction must naturally include its value relative to alternative offers. While the stockholders’ vote would only be coerced if an alternative offer were to emerge, the board cannot predict whether or not an alternative offer will be forthcoming at the time it agrees to the no-talk provision. Second, a strict reading of Unitrin’s requirement that a defensive measure allow the board latitude to discharge its duty of care on an ongoing basis could be used to prohibit no-talk provisions because the board thereby disables itself from being able to make an informed decision consistent with its duty of care to continue to recommend the underlying transaction should a competing offer emerge.
88. In ACE, the board of Capital Re had executed a stock-for-stock merger agreement with ACE Limited which included a no-talk provision which prohibited Capital Re from even considering an unsolicited offer unless certain conditions were met which included, inter alia, the requirement that the board of Capital Re conclude in good faith, based on the written advice of its outside legal counsel, that participating in such negotiations or discussions or furnishing such information was required in order to
invalidation of absolute lock-ups in *Omnicare* is applicable. Although the absolute lock-up in *Omnicare* did not employ a no-talk provision, the court’s invalidation of the agreement was based on the effect of the absolute lock-up rather than the validity of its constituent parts. Thus, employing a no-talk provision to create an absolute lock-up in the manner seen in *ACE* is no more valid than employing a section 251(c) provision, as in *Omnicare*.

4. *Section 251(c) Provisions*

a. In the Change of Control Context; Applying the *Revlon / Macmillan* Ex Post Approach or the *QVC* Ex Ante Approach

Although there is no case law directly addressing the issue, a section 251(c) provision is probably valid in a transaction that invokes *Revlon* duties. Standing alone, a section 251(c) provision does not limit the board’s ability to consider alternative offers and make an informed recommendation to the stockholders, nor does it present an economic barrier to a competing bid. However, a section 251(c) provision cannot be used in any combination of deal protection devices that would not satisfy enhanced scrutiny in the non-change of control context, discussed below.

b. In the Non-Change of Control Context

*Omnicare* confirms that, standing alone, section 251(c) provisions are valid and enforceable. However, the language of *Omnicare* leaves open the possibility that a section 251(c) provision may be invalid if the target company is subject to a controlling stockholder interest.

prevent the board from breaching its fiduciary duties to its stockholders. *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 96-100 (Del. Ch. 1999). The merger agreement also provided that Capital Re could only terminate the agreement if, among other things, Capital Re was not in material breach of any of the terms of the agreement. *Id.* at 99. *ACE* had also obtained stockholder voting agreements such that approval of the merger was a foregone conclusion once submitted by the board to a stockholder vote. *Id.* at 97. Because the transaction was of a type which generally does not invoke *Revlon* duties, *ACE* contended that neither Capital Re nor its legal counsel could conclude in good faith that its fiduciary duties required it to negotiate with another bidder. *Id.* at 107. Under this interpretation, the agreement operated as part of an absolute lock-up. *Id.* The court indicated that such an interpretation would probably make the agreement invalid. *Id.* at 104. However, the court avoided invalidating the agreement by interpreting the language to provide Capital Re with a fiduciary out by rejecting *ACE*'s contention that a board has no fiduciary duty to negotiate a superior offer simply because *Revlon* duties are not invoked. *Id.* at 107.

89. *Omnicare*, 818 A.2d at 938.

90. In *Omnicare*, the defendant board created an absolute lock-up by agreeing to a section 251(c) provision that operated in concert with voting agreements binding stockholders owning a majority of the company’s voting power. *Id.* at 925.

91. *Id.* at 937-38.

92. *Id.*

93. In *Omnicare*, the court held that a board’s decision to agree to a section 251(c) provision that operates in concert with stockholder voting agreements binding less than 100% of the stockholders to
Judicial Scrutiny of Deal Protection Devices in Delaware

*Omnicare* holds that combining a section 251(c) provision with stockholder voting agreements to form an absolute lock-up is per se invalid. Nonetheless, a section 251(c) provision can be validly combined with stockholder voting agreements that bind less than a controlling interest in the target company because that combination does not achieve an absolute lock-up.

*Omnicare* raises an interesting question as to whether a section 251(c) provision can be used in combination with a no-talk provision. On the one hand, combining these devices does not create an absolute lock-up. On the other hand, should a competing offer emerge after executing an agreement which includes this combination of deal protection devices, the stockholders alone will be left with the burden of approving or rejecting the transaction. The stockholder's decision will be based on uninformed speculation concerning the competing offer because the no-talk provision prevents the board from negotiating with the competing bidder and the section 251(c) provision prevents the board from terminating the protected agreement. Because the validity of no-talk provisions is already questionable after *ACE*, use in combination with a further limitation upon the board could invite express invalidation by a Delaware court.

5. Stockholder Voting Agreements

The standard of review does not affect stockholders' ability to execute create an absolute lock-up is per se invalid. *Id.* at 938. The court reasoned that because minority stockholders lack the power to influence corporate direction through the ballot, directors have a fiduciary duty to protect them. *Id.* at 937. However, the absence of a voting agreement would not allow the minority stockholders any greater influence upon the outcome of a vote to approve a merger. Thus, by the court's logic, even absent stockholder voting agreements, any time a controlling stockholder approves a merger submitted by the board under a section 251 provision, the board has failed to protect the minority stockholders because they have been unfairly coerced into accepting the merger and unfairly precluded from voting on an alternative transaction. Furthermore, the decision to adopt a section 251 provision abdicates the board's fiduciary duty to terminate the transaction when necessary to protect the financial interests of the minority stockholders.

A counter-argument might be that absent stockholder voting agreements, the concern that the minority will be coerced into accepting a less valuable transaction and precluded from considering a more valuable transaction is eliminated because a rational controlling stockholder will vote for the more valuable of the two. But consider the result if the controlling stockholder has not executed a voting agreement but has determined that the tax benefits of the protected stock-for-stock merger are preferable to the additional value per share to be received from a competing all-cash offer. The court's logic suggests that agreeing to a section 251 provision would have breached the board's fiduciary duty to protect the minority stockholders' financial interests because the board thereby abdicated its ability to terminate rather than submit the stock-for-stock merger to a stockholder vote decided by controlling stockholders subject to no duty to consider minority interests.

Interestingly, this interpretation conflicts with *McMullin*, in which the court held that where minority stockholders are powerless to out-vote the controlling stockholder's decision to approve a transaction, the directors only have the duty to act on an informed basis to independently ascertain how the merger consideration being offered in the third party transaction compares to the company's aggregate appraisal value. *McMullin* v. Beran, 765 A.2d 910, 920 (Del. 2000).

94. *Omnicare*, 818 A.2d at 938.
95. See *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 107 (Del. Ch. 1999).
V. WHAT IS WRONG WITH THE LAW IN DELAWARE REGARDING DEAL PROTECTION DEVICES?

A. The Delaware Supreme Court Should Expressly Commit to the Ex Ante Approach Articulated in QVC

The Delaware Supreme Court should expressly commit to the ex ante approach articulated in QVC because the ex post approach articulated in Revlon and Macmillan limits a board’s ability to discharge its fiduciary duty to act in stockholders’ best interests and usurps the proper role of the board of directors.

Deal protection devices create value for target company stockholders by securing the opportunity to sell their stock at a higher price. However, deal protection devices also limit the target company’s ability to negotiate other transactions. Therefore, deal protection devices only create value for target company stockholders when the deal they protect is the most valuable transaction available to the target company.

Where multiple bidders are engaged in an active contest for control of the target company, the target company’s board cannot be certain that a particular bidder’s offer represents the most value available because of the likelihood that it will be topped by a rival. In this circumstance, deal protection devices handicap the target company from considering other offers despite the fact that a superior offer is highly likely to emerge. Thus, deal protection devices have no place in an active contest for corporate control.

However, not all acquisitions involve an active contest for corporate control. Where the target company has canvassed the market but only one willing acquiror has emerged, the target company’s board may reasonably

96. Take for example, one bidder’s demand for a lock-up and/or a termination fee. Where no other bidder exists or is likely to emerge, acceding to these demands in return for an increase in the bidder’s offer benefits stockholders. However, where rival bidders are competing for control of the target company, acceding to one bidder’s demand for a lock-up and/or a termination fee can decrease the return to the target company’s stockholders.

To illustrate, assume a bidder “AC1” offers $40 per share to target company “TC,” and a rival bidder, “AC2” offers $41 per share. Assume that TC offers AC1 a lock-up and a termination fee in return for which AC1 agrees to pay $50 per share to acquire TC. However, the combined value of the lock-up and the termination fee is such that if TC changes its mind and agrees to be acquired by AC2 instead, $3 per share of any consideration offered by AC2 would effectively be diverted from TC stockholders to AC1 in the form of the discounted price of the asset subject to the lock-up and the flat payment of the termination fee. AC2 must now offer over $53 per share for TC stockholders to see an increased return. If AC2 then announces that it is willing to pay $52 per share but no more, the offer is superior on its face to AC1’s offer of $50 but will only return $49 per share to TC stockholders because of the lock-up and the termination fee. A superior bid for TC has thus been foreclosed to the detriment of TC stockholders who have lost $2 per share that they might otherwise have received.
believe that the acquiror's offer represents the most valuable transaction available. Even where the target company has received multiple offers, they may be final offers or offers of only limited negotiability. Where only one of those offers is adequate, or represents a significantly greater value than the others, the target company's board may also reasonably believe that it has identified the most valuable transaction available. In these circumstances, deal protection devices have the potential to create value for target company stockholders by securing and improving the most valuable transaction available because a superior offer is unlikely to emerge.

Delaware judicial doctrine properly prohibits a target company's board from agreeing to deal protection devices during an active bidding contest (a situation in which a superior offer is likely to emerge). However, the ex post approach to enhanced scrutiny articulated in Revlon and Macmillan belies language in those same cases indicating that deal protection devices may be valid in the absence of an active bidding contest.

Under an ex post approach, a target company's board is presented with a Hobson's choice: the board may validly adopt deal protection devices but will be subject to liability for failure to act in the best interests of the stockholders should those deal protection devices subsequently thwart a superior offer, regardless of whether that offer was reasonably foreseeable by the board. Thus, in order to avoid potential exposure to liability, the board has no choice but to refrain from adopting deal protection devices even when it reasonably determines that they will create value for target company stockholders because a superior offer is unlikely to emerge.

Furthermore, under an ex post approach, the risk that a court will invalidate deal protection devices if a superior offer emerges eliminates the security that they are intended to provide. Thus, they neither secure nor increase the value of a transaction with a rational acquiring company. An acquiring company that was not willing to negotiate absent deal protection devices will not be drawn to the table by deal protection devices that may be subsequently invalidated in the exact circumstance against which they are intended to protect. Similarly, an acquiring company willing to negotiate with the target company absent deal protection devices will not increase its offer in return for such illusory certainty. Thus, an ex post approach to enhanced scrutiny effectively prohibits the use of deal protection devices in transactions that result in a change of control, even where they are more likely to create rather than destroy value for the stockholders.

This approach is overly inclusive. Enhanced scrutiny is intended to protect

against the omnipresent specter of director self-interest. Where the board’s motive for approving deal protection devices cannot otherwise be confirmed, an ex post approach protects stockholders from the risk that the directors are acting self-interestedly. However, where the target company’s board makes a reasonable determination that a particular transaction offers the most value available to the stockholders, namely, that a superior offer does not exist and is unlikely to emerge, there is already protection against board self-interest. Under enhanced scrutiny, a board’s determination is only adjudged “reasonable” if it was made in good faith on an informed basis. A good faith and informed determination that a transaction is the best value available to the stockholders is not self-interested by definition. Thus, by establishing that its determination was reasonable, a board confirms the propriety of its motive for agreeing to deal protection devices.

Once the board’s motive is no longer at issue, an ex post approach can only be justified as protecting stockholders if the benefit of prohibiting deal protection devices outweighs the cost of prohibiting deal protection devices even when the board has made a reasonable determination that a superior offer neither exists nor is likely to emerge. If it does not, an ex post approach to applying enhanced scrutiny harms the target stockholders’ financial interests, which enhanced scrutiny is intended to protect.

Once a board has made a reasonable determination that a superior offer neither exists nor is likely to emerge, deal protection devices probably create more value than they destroy. In these circumstances, the emergence of a superior offer after execution of a merger agreement subject to deal protection devices is likely the result of that merger agreement’s signal to the market concerning the value of the target company. Where the merger agreement would not have occurred but for the target board’s accession to deal protection devices, the deal protection devices have not precluded consideration of a superior offer because a superior offer would not have emerged in their absence. Therefore, the value created by the deal protection devices is not offset by any amount due to having prevented stockholders from considering a superior offer.

However, where the deal protection devices were necessary only to increase the value of the acquiring company’s offer rather than to actually facilitate a merger agreement, it is possible that a subsequently emerging superior offer would have emerged even absent the deal protection devices. In addition, the

99. The benefit of prohibiting deal protection devices is the value created by allowing stockholders to consider a superior offer when the board’s reasonable determination is incorrect.

100. The cost of prohibiting deal protection devices is the value lost due to information asymmetry that prevents transactions or causes acquiring companies to discount their offers.

101. In other words, the value created by reducing information asymmetry is probably greater than the value lost by foreclosing the possibility of considering superior offers.
Judicial Scrutiny of Deal Protection Devices in Delaware

unlikely sometimes occurs, and a subsequently emerging superior offer might be one that would have emerged even absent a merger agreement of any kind.

Nonetheless, even if target stockholders are occasionally precluded from a more valuable transaction because the board’s reasonable estimation that a superior offer does not exist and is unlikely to occur turns out to be wrong, intuition dictates that such a determination is probably more often right. If the opposite were true, the long-standing dominance and success of director-managed commercial entities would be difficult to explain.

If a board’s reasonable determination that a superior offer does not exist and is unlikely to occur is more often right than wrong, then, on balance, decisions to agree to deal protection devices that create value for stockholders are probably of greater value to stockholders than the few superior offers that they may be precluded from considering when the unlikely occurs. A conclusive determination would require an econometric analysis that compares the average value created by deal protection devices to the average value foregone through preclusion of superior transactions. While such an analysis is outside of the scope of this Article, it is also outside the scope of the judicial function; Delaware courts are ill-suited to the task.

In QVC, the Delaware Supreme Court expressly recognized this concern and the resulting need for an ex ante approach in applying enhanced scrutiny. Under QVC, if the court finds that the board made a reasonable determination that a particular transaction offers the most value available to the target company’s stockholders, the court should ignore subsequent events such as the emergence of a superior offer. However, the Delaware Supreme Court’s commitment to the ex ante approach required by QVC remains untested. In QVC itself, Paramount’s decision not to attempt to modify the deal protection devices in its agreement with Viacom when that agreement was renegotiated, despite QVC’s consistently demonstrated intent to meet and exceed Viacom’s offers, was unreasonable even from an ex ante perspective.

The court has yet to hear a case in which the board made a reasonable determination to agree to deal protection devices in a transaction that would result in a change of control that thwarted a subsequent, unexpected, superior offer. Although the court cannot resolve this ambiguity sua sponte, the court should take the issue into consideration when determining the cases to which it will grant certiorari. Until it does, dealmakers must be wary of relying on QVC to use deal protection devices in transactions that will result in a change of control, and target stockholder financial interests are likely to suffer.

B. The Delaware Supreme Court Should Validate the Use of Absolute Lock-ups

103. See supra note 43.
in Appropriate Circumstances

Assuming that a qualified board of directors' reasonable determination is more often right than wrong, the Delaware Supreme Court's per se invalidation of absolute lock-ups in Omnicare is overly inclusive because it prevents the use of absolute lock-ups even when they are likely to benefit stockholders.\(^\text{104}\) Among deal protection devices, absolute lock-ups present the greatest risk of foreclosing the target company from considering a superior competing offer. However, they also can create the most value by eliminating rather than reducing the risk that the target company will not consummate the transaction. Eliminating this risk prevents any discount that would otherwise be applied, and thus maximizes the price the acquiring company is willing to pay to acquire the target company.

1. The Delaware Supreme Court Erred in Omnicare

In Omnicare, Omnicare Inc. challenged NCS Healthcare Inc.'s board's decision to agree to a section 251(c) provision which operated in concert with voting agreements, binding stockholders who held voting control over NCS to achieve an absolute lock-up of a merger with Genesis Healthcare Ventures Inc.\(^\text{105}\) The Delaware Supreme Court invalidated the NCS board's decision on two bases. The first basis was that such a decision cannot satisfy enhanced scrutiny under Unocal because it coerces minority stockholders, who are not subject to voting agreements, into accepting the underlying transaction and precludes them from voting for an alternative transaction.\(^\text{106}\) The second basis was that even absent enhanced scrutiny, such a decision violates the board's basic fiduciary duty to protect minority stockholders who are not subject to voting agreements.\(^\text{107}\) Thus, both bases depend on the principle that the board has a fiduciary duty to protect minority stockholders, who are not subject to voting agreements, from the will of the majority.

This principle is unfounded. The court's citations to McMullin and QVC are inapposite and the duty articulated exceeds the requirements of even higher standards of review.

In McMullin, the board of directors delegated the negotiations of the company's acquisition to its controlling stockholder.\(^\text{108}\) The court held that "[t]he [board], in carrying out its affirmative duty to protect the interests of the minority, could not abdicate its obligation to make an informed decision on the

\(^{104}\) Absolute lock-ups are likely to benefit stockholders when the board has made a reasonable determination that a superior offer neither exists nor is likely to emerge.

\(^{105}\) Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 918 (Del. 2003).

\(^{106}\) Id. at 936.

\(^{107}\) Id. at 937.

fairness of the merger by simply deferring to the judgment of the controlling shareholder." However, the court also held that under the circumstances, the board could not "effectively seek an alternative to the proposed sale by auction or agreement and had no fiduciary responsibility to engage in either futile exercise" because the majority stockholder had the right to vote in favor of the transaction it proposed. The court noted that because the minority stockholders were powerless to out-vote the controlling stockholder, they were only able to decide whether to accept the transaction or to seek an appraisal value of their shares. Accordingly, the directors had the duty to act on an informed basis to independently ascertain how the merger consideration being offered in the third party transaction compared to the company's aggregate appraisal value.

Thus, *McMullin* does not support the proposition for which it is cited by the court in *Omnicare*. In *Omnicare*, the court seems to imply that *McMullin* requires the board to maintain its ability to terminate a merger sponsored by a controlling stockholder in order to protect minority stockholder interests when, in fact, *McMullin* expressly disavows such a duty. *McMullin* requires only that the board make an informed recommendation as to the fairness of the merger. In other words, the board is required to retain the latitude to inform the stockholders' vote, not to thwart it. The facts of *Omnicare* indicate that the board acted on an informed basis in negotiating the terms of the Genesis merger, in initially recommending stockholder approval, and in withdrawing that recommendation once the Omnicare proposal emerged in order to recommend that the minority stockholders vote to reject the Genesis merger. This is all that *McMullin* requires.

In *QVC*, the court noted that:

In the absence of devices protecting the minority stockholders, stockholder votes are likely to become mere formalities where there is a majority stockholder. For example, minority stockholders can be deprived of a continuing equity interest in their corporation by means of a cash-out merger. Absent effective protective provisions, minority stockholders must rely for protection solely on the fiduciary duties owed to them by the directors and the majority stockholder, since the minority stockholders have lost the power to influence corporate direction through the ballot.

In *QVC*, the court was concerned about mergers in which stockholders

109. *Id.* at 919-20.
110. *Id.* at 920.
111. *Id.* at 919.
112. *Id.*
115. *Id.* at 919.
receive stock in a corporation controlled by a controlling stockholder which could deprive them of a continuing equity interest through a cash-out merger. Thus, the circumstances themselves are inapposite because the court was concerned about protecting the minority from situations in which the controlling stockholder has a conflict of interest. That circumstance was lacking in *Omnicare* because NCS’s controlling stockholders stood to gain nothing “to the exclusion of, and detriment to the minority stockholders”\(^{118}\) as a result of the Genesis merger.

The court’s holding in *Omnicare* articulates a duty to protect any percentage of minority stockholders not subject to voting agreements.\(^{119}\) This means that even absent a conflict of interest, 100 percent of the target company’s stockholders must execute voting agreements before the board can agree to an absolute lock-up.

In the absence of a conflict of interest there is no basis for importing the requirement of unanimous stockholder approval. Once the duty to protect the minority stockholders articulated by the court is removed, the court’s holding necessarily falls apart. Because the court acknowledges that the controlling stockholders were not coerced, the finding of coercion is without merit. The court refrained from referring to the minority in its finding of preclusion, but the logic is identical. Surely the controlling stockholders’ own execution of “the linchpin of Genesis’ proposed tripartite defense”\(^{120}\) cannot support a finding of preclusion by the board where the controlling stockholders intended for the board to agree to an absolute lock-up. Thus the controlling stockholders’ implicit consent to the absolute lock-up militates against a finding of either coercion or preclusion. Absent a conflict of interest, the minority’s failure to consent is irrelevant to consummation of the transaction under *McMullin*.

The court’s holding that the board did not have authority to agree to an absolute lock-up because “to the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable,”\(^{121}\) also falls apart without a duty to protect the minority stockholders from consummation of the transaction. Simply put, an absolute lock-up cannot limit the exercise of a duty that does not exist.

### 2. There is an Alternative Basis to Support the Holding in Omnicare

However, the court’s decision in *Omnicare* may be supportable on

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118. This standard to determine whether a controlling stockholder has a conflict of interest is articulated in *Sinclair Oil v. Levien*, 280 A.2d 717, 720 (Del. 1971).
120. *Id.* at 934.
121. *Id.* at 936 (quoting *QVC*, 637 A.2d at 51).
alternative grounds. A colorable argument can be made that by limiting the board’s ability to terminate the underlying transaction should a superior offer emerge, agreeing to an absolute lock-up limits the board’s fiduciary duty to act in the best interests of the stockholders on an ongoing basis. As the court held in *QVC*, “[t]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.”  

Similarly under *Unitrin*, the board’s response must be within a range of reasonableness, the *ratio decidendi* of which is “a need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats.”  

This requirement prohibits defensive responses that would limit the board’s ability to discharge its fiduciary duties.

3. Per Se Invalidation on the Basis of the Board’s Duty to Act in the Best Interests of the Stockholders Relies upon a Determination that Delaware Courts Are Unsuited to Make

The foregoing alternative basis to support the court’s holding in *Omnicare* stands on firmer conceptual ground than the duty to protect the minority articulated by the court. Yet, per se invalidation on the basis of the board’s duty to act in the best interests of the stockholders on an ongoing basis suffers from the same flaws noted above in regards to the Delaware Supreme Court’s ex post approach to enhanced scrutiny in general. It expressly prohibits the use of absolute lock-ups, even where the target company’s board makes a reasonable determination that a superior offer neither exists nor is likely to emerge. In this circumstance, an absolute lock-up is more likely to create rather than to destroy value for the stockholders. Thus, per se invalidation actually limits the board’s ability to discharge its fiduciary duty to act in the best interests of the stockholders.

As with an ex post approach, per se invalidation of absolute lock-ups can only be justified if the benefit of prohibiting absolute lock-ups, even when the board has made a reasonable determination that a superior offer neither exists nor is likely to emerge,  

outweighs the cost of prohibiting absolute lock-ups.  

If it does not, per se invalidation is detrimental to the target stockholders’ financial interests, which enhanced scrutiny is intended to protect.

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122. *QVC*, 637 A.2d at 51.
124. I.e., the value created by allowing stockholders to consider a superior offer when the board’s reasonable determination is incorrect.
125. I.e., value lost due to information asymmetry that prevents transactions or causes acquiring companies to discount their offers.
Assuming that a qualified board of directors' reasonable determination is more often right than wrong, per se invalidation prohibits use of absolute lock-ups even in circumstances where they create value more often than they preclude stockholder consideration of superior offers. Whether or not this is detrimental to stockholder interests is also an empirical question requiring econometric analysis. Thus, the validity of per se invalidation of absolute lock-ups relies upon the Delaware courts' ability to make a determination for which the courts lack the requisite skill.

4. Delaware Courts Should Recognize that Under Certain Circumstances, Agreeing to an Absolute Lock-up is Consistent with the Board's Fiduciary Duty to Manage the Corporation in the Best Interests of its Stockholders

Delaware courts have an alternative to per se invalidation of absolute lock-ups. The courts should recognize that where a target company's disinterested board of directors has adequately canvassed the market and negotiated with available bidders in a competitive environment to reasonably determine that a superior offer neither exists nor is likely to emerge, a decision to agree to contractual provisions that limit the board's ability to negotiate other offers is consistent with the board's fiduciary duty to manage the corporation in the best interests of its stockholders.

This recognition should allow for the use of absolute lock-ups in those circumstances, even if the transaction will result in a change of control. To use the language of Unocal, the courts should recognize that using an absolute lock-up to limit a board's ability to negotiate competing transactions is a proportional response to the threat of diminished value and falls within a range of reasonableness when the board reasonably determines that a superior offer is unlikely to emerge.

Pursuant to QVC, a reviewing court should determine "whether the directors made a reasonable decision, not a perfect decision. If [the] board selected one of several reasonable alternatives, a court should not second guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination."

126. I.e., whether the value that would be created by absolute lock-ups but is prevented because of per se invalidation exceeds the value from those unlikely superior offers which stockholders are currently able to consider but would be precluded by reasonable use of absolute lock-ups.

127. This proposal finds support in ACE, in which the court commented that there may be limited circumstances in which a board can prudently place itself in the position of not being able to entertain and consider a superior proposal to a transaction dependent on a stockholder vote, one example of which might be "where a board has actively canvassed the market, negotiated with various bidders in a competitive environment, and believes that the necessity to close a transaction requires that the sales contest end." ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 107 (Del. Ch. 1999).

reasonably conclude that a particular transaction offers the most value available to the stockholders while competing bidders remain willing to negotiate their offers in good faith. Thus, valid use of absolute lock-ups would be limited to circumstances in which a target company is faced with inferior, non-negotiable competing offers or a complete lack of competing offers altogether.

Because a court should examine the reasonableness of the board’s decision at the time the decision was made, the board should not be held accountable for the subsequent emergence of a superior offer. The emergence of a superior offer is either the result of the protected agreement, in which case it is illusory, or it is such an unlikely occurrence that it would have been unreasonable for the board to forego deal protection to defend against it. Where a board reasonably concludes that it is highly unlikely that a superior offer will emerge, the mere possibility that a superior offer will emerge is not a prudent basis on which to forego an absolute lock-up which will secure or improve the most valuable transaction available.

C. The Delaware Supreme Court Should Reverse Omnicare

*Omnicare* presents a model example of a target board making a reasonable decision to agree to an absolute lock-up after having adequately canvassed the market to determine that the underlying stock-for-stock merger constituted the most valuable transaction available to the stockholders.\(^1\) NCS was already in a precarious financial position when it received notice of default and acceleration from its creditors.\(^2\) After diligently canvassing the market, the board of NCS was unable to identify a willing acquiror.\(^3\) Omnicare, its sole suitor, refused to consider any deal other than an asset sale in bankruptcy and actively attempted to lure away NCS customers.\(^4\) Under those circumstances, NCS agreed to an absolute lock-up with Genesis, which had made it clear that it would not negotiate with NCS without such protection because it had already suffered an eleventh hour loss to Omnicare in a prior transaction.\(^5\) NCS thereby guaranteed a return to its stockholders of over $43.2 million where the alternative was a bankruptcy in which the stockholders would have received nothing.\(^6\)

The court notes that “the marked improvements in NCS’s financial situation during the negotiations with Genesis strongly suggests that the NCS

\(^1\) Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 921 (Del. 2003).
\(^2\) Id. at 920-21.
\(^3\) Id. at 921.
\(^4\) Id. at 923.
\(^5\) Id. at 921-25.
board should have been alert to the prospect of competing offers or, as eventually occurred, a bidding contest.” Yet at the time the NCS board agreed to the lock-up, the only alternative on the table was a highly conditional offer from Omnicare, which had previously rejected a merger agreement and engaged in exclusive negotiations with NCS creditors concerning a bankruptcy proposal.

Under the circumstances, the board’s concern that “the risk of losing the Genesis proposal was too substantial” seems to fall well within the “range of reasonableness” required by Unitrin. Furthermore, if the marked improvements in NCS’s financial situation were such that the NCS board should have been alert to the prospect of competing offers, how come there were no other offers? The board of NCS initially approached over 50 companies concerning its acquisition. Thus, its status as a target company was public knowledge. Despite that fact, Omnicare was the only bidder to emerge. This suggests that Omnicare’s offer was a direct result of the Genesis agreement rather than a product of NCS’s improved financial performance.

The reasonableness of the board’s calculus is also supported by the board’s incentives. Two of the four board members were controlling stockholders and no conflict of interest was alleged against either one. Thus, the board’s incentives for approving the absolute lock-up of the Genesis merger were entirely aligned with the minority stockholders that the court takes such pains to protect. The board was solely concerned with maximizing stockholder value.

Because the decision by the board of NCS was reasonable at the time it was made, the value of the subsequent Omnicare proposal is irrelevant. Nonetheless, the illusory value of that subsequent offer provides a prime example of why a board which makes a reasonable determination that a particular transaction offers the most value available should not be held accountable for the subsequent emergence of a superior offer.

Omnicare’s “superior offer” appears to have been the direct result of the agreement between NCS and Genesis. Omnicare only submitted an offer once the agreement with Genesis ensured that NCS would not be put into bankruptcy where Omnicare could buy NCS assets on the cheap. Because Genesis was unwilling to negotiate a transaction without an absolute lock-up, it follows that the Omnicare offer was in fact a product of the lock-up itself. Therefore, the court’s holding that the lock-up precluded NCS stockholders from considering the Omnicare offer is in error. It is a stark reflection of the manner in which an ex post perspective can lead to absurd results.

135. *Id.* at 938 n.84.
136. *Id.* at 924.
137. *Id.* at 920.
138. *Id.* at 918-19.
139. *Id.* at 923.
In *Omnicare*, the board made a reasonable determination that the Genesis merger offered the most value available to the NCS stockholders. Accordingly, a judicial recognition that where a target company’s disinterested board of directors has adequately canvassed the market and negotiated with available bidders in a competitive environment to reasonably determine that a particular transaction offers the most value available to the target company’s stockholders. This decision to agree to an absolute lock-up is consistent with the board’s fiduciary duty to manage the corporation in the best interests of its stockholders and would demand a reversal of *Omnicare*.

VI. CONCLUSION

Directors have a duty to act in stockholders’ best interests. In order to enforce that duty, Delaware courts scrutinize director conduct. Because the skill set necessary for reviewing the substantive merits of directors’ decisions is outside the scope of the judicial training, Delaware courts generally evaluate the fairness of directors’ decision-making process. Where the board’s decision-making process satisfies the required standard, Delaware courts defer to directors’ business judgment concerning the substantive merits of the challenged course of action.

However, by taking an ex post approach to enhanced scrutiny, and ruling absolute lock-ups per se invalid, the Delaware Supreme Court has enforced a substantive conclusion that deal protection devices in the change of control context, and absolute lock-ups in any context, are not in the best interests of stockholders because they destroy more value than they create. This debatable conclusion is probably detrimental to stockholder interests because it prevents the board from using deal protection devices in the change of control context, and using absolute lock-ups in any context, even when the board reasonably determines that they are in the stockholders best interests. As a result, it limits directors’ discretion in discharging their fiduciary duty to act in stockholders’ best interests. Furthermore, it usurps the proper role of the board in making substantive business decisions.

Accordingly, the Delaware Supreme Court should: (1) expressly commit to the ex ante approach to enhanced scrutiny articulated in *QVC* at the next available opportunity; (2) validate the use of absolute lock-ups in appropriate circumstances by recognizing that where a target company’s disinterested board of directors has adequately canvassed the market and negotiated with available bidders in a competitive environment to reasonably determine that a

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140. *Id.* at 925.
141. The reasonableness of the board’s decision alone is sufficient to mandate reversal. However, even from an equitable standpoint, the propriety of reversal is reinforced by the lack of harm to NCS stockholders that resulted from the absolute lock-up, because the Omnicare offer was a direct result of the Genesis agreement and thus presented an illusory improvement.
superior offer neither exists nor is likely to emerge, a decision to agree to contractual provisions that limit the board’s ability to negotiate other offers is consistent with the board’s fiduciary duty to manage the corporation in the best interests of its stockholders; and (3) reverse *Omnicare* in line with this proposed recognition.