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# The Costs and Benefits of Precommitment: An Appraisal of Omnicare v. NCS Healthcare

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## The Costs and Benefits of Precommitment: An Appraisal of *Omnicare v. NCS Healthcare*

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#### Abstract

In *Omnicare v. NCS Healthcare*, the Delaware Supreme Court recently announced a bright-line rule against precommitment in mergers and acquisitions. Even in the context of a "friendly" merger, transacting parties may not fully protect their deal from intervening bidders and instead must insert an escape clause, in the form of a fiduciary out, in their merger agreements. As a result, targets can no longer offer contractual certainty as a part of the transaction.

This article engages in a close analysis of the *NCS* opinion, first exposing the weaknesses in its doctrinal foundations, then analyzing its implications from the perspective of shareholder welfare. It finds that the *NCS* rule is both unsupported by existing law and harmful to shareholder welfare. The article then draws upon economic theory to propose an alternative, the "market check rule," that would control the costs of commitment while preserving the ability of target boards, under certain circumstances, to follow an affirmative precommitment strategy.

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#### I. Introduction

For almost two decades, the law of mergers and acquisitions has operated according to a set of dichotomies. Two fiduciary duties, the duty of loyalty and the duty of care, guide director conduct.<sup>1</sup> Two standards of review, business judgment deference and enhanced scrutiny, are applied by courts.<sup>2</sup> The applicable standard is determined by a pair of threshold questions also involving a set of dichotomies. Does the transaction involve a change-of-control or not? And is the transaction hostile or friendly?

Although the answers given by a schematic of binary oppositions may seem artificial or overly simplistic—basically, change-of-control transactions trigger enhanced scrutiny, while non-change-of-control deals do not,<sup>3</sup> and friendly acquisitions are granted judicial deference while hostile acquisitions are likely to occasion another form of

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<sup>&</sup>lt;sup>1</sup> See generally Victor Brudney, Contract and Fiduciary Duty in Corporate Law, 38 B.C. L. REV 595, 599 n.9 (1997) ("Legal conventions divide fiduciary obligations into obligations of loyalty and obligations of care."). Courts and commentators sometimes highlight other fiduciary duties, especially good faith, as significant elements of board conduct. See, e.g., Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) ("The directors of Delaware Corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith."). However, at least until recently, most judicial analyses of director conduct have focused on care and loyalty, treating good faith as a generally present prerequisite to the application of the business judgment rule. See generally Stephen M. Bainbridge, The Business Judgment Rule as an Abstention Doctrine, FORTHCOMING, \_\_\_ VANDERBILT LAW REVIEW \_\_\_ (2004) (noting that "before the [business judgment] rule comes into play, various prerequisites must be satisfied."); Hillary A. Sale, Delaware's Good Faith, FORTHCOMING, 89 CORNELL LAW REVIEW \_\_\_ (2004) (arguing that a line of recent Delaware decisions have reawakened good faith as a separate fiduciary principle with substantive impact).

<sup>&</sup>lt;sup>2</sup> Courts may apply a third standard, "entire fairness," in the case of conflicts of interest. *See infra* note 40. Although acquisitions present target directors with a kind of conflict of interest—i.e., losing their board seats—the Delaware courts have long held that acquisitions, without evidence of a direct pecuniary interest, do not trigger the entire fairness standard. *See* Pogostin v. Rice, 480 A.2d 619, 626-27 (Del. 1984) (applying the business judgment rule to board action in takeovers). Although *Unocal* arguably over-ruled *Pogostin* in announcing a standard of enhanced scrutiny in the takeover context, it did not move takeover jurisprudence back to the more rigorous standard of entire fairness. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). *See also infra* TAN XX-XX.

<sup>&</sup>lt;sup>3</sup> See infra TAN 63.

heightened scrutiny<sup>4</sup>—they provided enough clarity to support a massive wave of merger activity in the 1990s.<sup>5</sup>

But all of that has now changed.

This past spring, in the case of *Omnicare v. NCS Healthcare*,<sup>6</sup> the Delaware Supreme Court split three Justices to two<sup>7</sup> in a decision that applied a form of heightened scrutiny to a friendly merger not involving a change-of-control.<sup>8</sup> Over the objections of two vigorous dissents, the majority articulated a bright-line rule that requires target boards to preserve effective termination rights between the signing and closing of a merger transaction.<sup>9</sup> Because merger agreements must include an escape clause, known as a "fiduciary out," enabling the target's board of directors to abandon the initial agreement should a premium bid arise, transacting parties may no longer include deal

<sup>4</sup> See infra Part II.B.

<sup>&</sup>lt;sup>5</sup> See generally Patrick A. Gaughan, Fifth U.S. Merger Wave Continues Unabated, N. Y. L. J., Nov. 13, 2000, at s5 (documenting the "fifth wave of merger activity," starting in 1993 and lasting through 2000).

<sup>&</sup>lt;sup>6</sup> Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195 (Del.S.Ct. Apr. 4, 2003) (hereinafter NCS).

<sup>&</sup>lt;sup>7</sup> This fact alone marks *NCS* as an unusual and noteworthy case and suggests deep divisions on the Court. *See generally* David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 129 (1997) ("Even on deeply controversial issues, such as those that arose during the takeover wave of the 1980s, Delaware's justices almost invariably speak with a single voice."). Moreover, in failing to speak with one voice in a decision that marks a significant change in the law, the decision recalls another famous, perhaps infamous 3-2 holding—that is, *Smith v. Van Gorkom*. 488 A.2d 858 (Del. 1985) (hereinafter *Van Gorkom*).

<sup>&</sup>lt;sup>8</sup> This article follows the standard approach in the literature of treating Delaware law as national corporate law or, at least, as the national leader in corporate law with significant influence on the corporate law of other states. *See generally* Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 350 (2001) ("The aggregated choices of a majority of publicly traded U.S. corporations have resulted in a convergence on the Delaware General Corporation Law as a de facto national corporate law.").

<sup>&</sup>lt;sup>9</sup> See infra TAN and note 37.

<sup>&</sup>lt;sup>10</sup> See generally William T. Allen, Understanding Fiduciary Outs: The What and Why of an Anomalous Concept, 55 BUS. LAW. 653 (2000) (describing the role of the "fiduciary out," a clause that permits boards of directors to get out of an agreement if they determine in a good faith that performance of the agreement is inconsistent with their fiduciary duties).

protection provisions that provide the initial acquiror with certainty that its transaction will close.

By writing this rule into the law of negotiated acquisitions, an area that Delaware courts had previously treated with great deference, <sup>11</sup> the *NCS* Court rejects the doctrinal dichotomies that have long shaped merger transactions and reaches for a broad principle to guide the merger process: Directors sign up deals, and shareholders accept or reject them. <sup>12</sup> Directors cannot commit to a particular deal, the Court seems to say, in such a way that competing bidders are effectively precluded, thereby narrowing the choices ultimately available to shareholders. Instead, the possibility that the deal will be renegotiated with a new bidder must remain open until the shareholders have voted. The board may not exert such control in signing the deal that they essentially foreclose options that might otherwise have arisen prior to the shareholder vote.

But requiring boards to keep their options open between the signing and closing of a merger agreement effectively circumscribes some of the actions available to *directors*. If boards must include fiduciary outs in their merger agreements, there is some sense in which they cannot commit to deals at all. It does not mean much, after all, to agree to something that you can easily get out of. And if boards must be able to get out of a potential deal the moment a premium bid appears, targets can no longer offer transactional certainty to would-be acquirors, promising a high level of confidence that the deal will close in exchange for another concession in the bargain, and can no longer follow a "precommitment strategy," committing to sell to a particular bidder at some

<sup>11</sup> See generally Leo E. Strine, Jr., Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements, 56 Bus. Law. 919 (2001) (criticizing the rigid doctrinal categorization and arguing in favor of greater application of *Unocal* scrutiny in merger transactions).

point in the negotiation process in order to force the hand of the other bidders at the table.<sup>13</sup> Because precommitment strategies may be used for the benefit of the target corporation and its shareholders, a rule that takes these away threatens to harm shareholder welfare.

The issues raised in *NCS* are thus highly relevant not only to practitioners seeking to protect their clients' deals, but also to academics engaged in a number of corporate law debates. The *NCS* opinion opens questions regarding the appropriate standard of review for takeovers and the relevance of prior doctrinal paradigms.<sup>14</sup> It raises concerns regarding the efficiency of Delaware law from the perspective of shareholder welfare maximization<sup>15</sup> and engages the emerging literature on corporate precommitments.<sup>16</sup> Finally, the clash between the majority and dissenting opinions offers competing visions

<sup>12</sup> See DEL.CODE ANN. TIT. 8, §251(c) (2002) (providing for shareholder approval of merger agreements).

<sup>&</sup>lt;sup>13</sup> For further discussion of the benefits of transactional certainty and precommitment strategies, see *infra* Part IV.

<sup>&</sup>lt;sup>14</sup> See generally William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., A Critique Of Van Gorkom And Its Progeny As A Standard Of Review Problem, 96 Nw. U.L. REV. 449 (2002) (discussing judicial review under the duty of care); Ronald J. Gilson, Unocal Fifteen Years Later (And What We Can Do About It), 26 DEL. J. CORP. L. 491 (2001) (criticizing lack of judicial scrutiny applied to takeover defenses); Ronald J. Gilson & Reinier Kraakman, Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?, 44 Bus. Law. 247 (1989) (discussing promise of Unocal as an intermediate standard of review); Marcel Kahan, Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence, 19 J. CORP. L. 583, 589 (1994) (evaluating the standards of review in the takeover context and the "allocation of power between directors, shareholders, and courts that these rules create"); Harvey L. Pitt, On The Precipice: A Reexamination Of Directors' Fiduciary Duties In The Context Of Hostile Acquisitions, 15 DEL. J. CORP. L. 811, 817 (1990) (proposing "the creation of a bipartisan, national commission... to articulate a contextual framework for the takeover process").

<sup>&</sup>lt;sup>15</sup> Most corporate law scholars address efficiency concerns from the perspective of shareholder welfare maximization. *See generally* Stephen M. Bainbridge, *In Defense Of The Shareholder Wealth Maximization Norm: A Reply To Professor Green*, 50 Wash & Lee L. Rev. 1423 (1993) ("Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers."). However, a number of scholars remain hostile to this view of corporate law. *See*, *e.g.*, LAWRENCE E. MITCHELL, ED., PROGRESSIVE CORPORATE LAW (1995) (collecting scholarship generally hostile to the norm of shareholder welfare maximization).

<sup>&</sup>lt;sup>16</sup> See infra TAN and notes XX – XX.

of the basic corporate law separation of powers issue—that is, board versus shareholder primacy.<sup>17</sup>

This article engages in a close analysis of the NCS opinion, focusing on its doctrinal foundations as well as its policy implications. After this introduction, Part II provides a brief overview of the relevant factual and legal background. Part III examines the majority's use of existing doctrine and argues that existing law did not compel the majority's conclusion, but rather that the majority stretched the law to announce its hostility to strong deal protection provisions. However, as addressed in Part IV, there are a number of situations, including the facts of NCS itself, in which shareholder welfare may be improved by mechanisms that enable boards to commit to a transaction with certainty. As a result, shareholder welfare will be harmed by a rule that would preclude directors from employing commitment strategies. This article therefore proposes, in Part V, an alternative to the majority's bright-line rule, drawing upon economic theory as well as the facts and circumstances surrounding the transaction to propose a rule that would support the ability of target boards, under certain circumstances, to adopt an affirmative precommitment strategy. The article then closes, in Part VI, with a brief summary and conclusion.

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<sup>&</sup>lt;sup>17</sup> Compare Stephen M. Bainbridge, The Board of Directors as Nexus of Contracts, 88 IOWA L. REV. 1 (2002) (situating model of director primacy within economic conception of the firm as a nexus of contracts) (hereinafter Bainbridge, Board as Nexus); Stephen M. Bainbridge, Director Primacy in Corporate Takeovers: Preliminary Reflections, 55 STAN. L. REV. 791 (2002) (advocating model of director primacy in context of corporate acquisitions); and Stephen M. Bainbridge, Director Primacy: The Means And Ends Of Corporate Governance, 97 Nw. U.L. REV. 547 (2003) (arguing that a model of director primacy best explains corporate law); with Robert B. Thompson and D. Gordon Smith, Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers, 80 TEX. L. REV. 261 (2002) (endorsing a model of shareholder primacy) (hereinafter Thompson & Smith, Sacred Space); and Robert B. Thompson, Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No," 67 U.

## II. Commitment in Context: Factual and Legal Background

## A. A Tale of Three Companies: NCS, Genesis, and Omnicare

During the 1990s, NCS was a thriving company in the healthcare industry. By the end of the decade, however, changes in healthcare regulation and insurance practices had sent the company's fortunes into a downward spiral of falling revenues and declining share prices. NCS common shares, which had traded above \$20 in January 1999, slid to \$5 by the end of that year. Defaults on \$350 million in debt came next, leaving NCS common shares trading below a dollar and casting serious doubt on the viability of NCS as a stand-alone business.

Confronted with these difficulties, the NCS board sought a transaction to save the company. It was a long search, beginning in February 2000 and not ending until July 2002, when the NCS- Genesis merger agreement was signed. During those two years, NCS worked with two different investment banks, <sup>20</sup> each of which engaged in a broad canvassing of the market, soliciting over fifty prospective bidders. <sup>21</sup> Notwithstanding these efforts, the process yielded only two interested parties, Omnicare and Genesis.

CIN. L. REV. 999 (1999) (arguing that judicial limitations on anti-takeover devices demonstrate commitment to shareholder primacy).

<sup>&</sup>lt;sup>18</sup> NCS, at \*11.

<sup>&</sup>lt;sup>19</sup> *Id*.

<sup>&</sup>lt;sup>20</sup> From February 2000 until December 2000, NCS worked with UBS Warburg. In December 2000, NCS retained Brown, Gibbons, Lang & Company. *Id.*, at \*11-12.

<sup>&</sup>lt;sup>21</sup> *Id*.

Omnicare and Genesis had a history together. Having lost a previous acquisition attempt to a last minute overbid by Omnicare, <sup>22</sup> Genesis insisted that it not be treated as a "stalking horse" merely to drive up the price of NCS shares in a bidding contest. <sup>23</sup> Meanwhile, the only transaction that Omnicare seemed willing to consider was an asset sale in bankruptcy that offered slim recovery for NCS noteholders and no recovery for NCS stockholders. <sup>24</sup> By contrast Genesis proposed a transaction out of the bankruptcy context that would fully repay NCS noteholders and also provide some recovery for its stockholders. <sup>25</sup> As NCS and Genesis neared agreement, Omnicare launched a last minute bid for NCS. <sup>26</sup> The NCS board met to consider the Omnicare proposal, but because it carved out significant exit rights for Omnicare and created an "unacceptable risk" that

Genesis... had tried to acquire... an institutional pharmacy, I don't remember the name of it. Thought they had a deal and then at the last minute, Omnicare outbid them for the company in a like 11:59 kind of thing, and ... they were unhappy about that.

Id., at \*20.

Although the two proposals are somewhat awkward to compare, due to their different transaction forms, the Genesis proposal was clearly far superior to the latest bid from Omnicare. First, the Noteholders were to receive 100% of the face value of the Notes, rather than between 70% and 80%. Second, the stockholders were to receive approximately \$ 1 per share, as opposed to nothing. Finally, given the structure of the transaction as a merger, rather than an asset sale in bankruptcy, the trade and other unsecured creditors stood to receive full value for their claims.

In re NCS Healthcare, Inc., Shareholders Litigation, 2002 Del. Ch. LEXIS 133, at \*18-19 (Del. Ch., Nov. 25, 2002).

<sup>&</sup>lt;sup>22</sup> *Id.*, at \*19-20. According to the testimony of a banker for NCS:

<sup>&</sup>lt;sup>23</sup> *Id.*, at \*16-17 ("Genesis wanted a degree of certainty that to the extent it was willing to pursue a negotiated merger agreement, it would be able to consummate the transaction it negotiated and executed.") (internal quotations and punctuation omitted).

<sup>&</sup>lt;sup>24</sup> *Id.*. at \*13-14.

<sup>&</sup>lt;sup>25</sup> Genesis' June 2002 transaction proposal was designed to take place outside of the bankruptcy context and included "repayment of the NCS senior debt in full, full assumption of trade credit obligations, an exchange offer or direct purchase of the NCS Notes ... equal to the par value of the NCS Notes..., and \$20 million in value for the NCS common stock." *Id.*, at \*17. Upon a comparison of the Genesis proposal with the alternatives that Omnicare had offered to date, the Chancery Court agreed with the NCS board that Genesis offered the superior alternative:

Genesis would abandon its bid, leaving NCS with only the highly contingent Omnicare offer, the board rejected it.<sup>27</sup> Nevertheless, the NCS board was able to use the Omnicare offer to extract further price concessions from Genesis, in return for which Genesis insisted on the signing of a well-protected merger agreement by midnight the following day.<sup>28</sup> NCS agreed, and by the end of the day on July 28, 2002, NCS and Genesis had a deal.

The NCS-Genesis merger agreement contained a standard no-talk provision as well as customary termination fees.<sup>29</sup> The most significant deal protection, however, was the combination of a must-submit covenant with voting agreements from NCS's Chairman, Jon Outcalt, and CEO, Kevin Shaw. The must-submit covenant provided that the NCS board would submit the NCS-Genesis agreement to its shareholders regardless of any subsequent change in the board's recommendation,<sup>30</sup> and the voting agreements committed a majority of NCS's voting power to the approval of the transaction.<sup>31</sup> These

<sup>&</sup>lt;sup>26</sup> The most significant out was an expansive due diligence covenant, permitting Omnicare to abandon or restructure the deal should unfavorable items arise in the course of its due diligence review. Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*22 (Del.S.Ct. Apr. 4, 2003).

<sup>&</sup>lt;sup>27</sup> *Id.*, at \*23.

<sup>&</sup>lt;sup>28</sup> *Id.*. at \*24.

<sup>&</sup>lt;sup>29</sup> The no talk provision contained a "fiduciary out" permitting the NCS board to consider unsolicited bids that seemed likely to result in a "superior transaction." Total fees in the event of termination of the agreement amounted to \$11 million, or 3.24% of deal value. *Id.*, at \*27. *See also* Press Release: Genesis Health Ventures to Acquire NCS HealthCare, July 29, 2002, filed as Exhibit 99.1 to NCS Healthcare, Inc., Current Report on Form 8-K, dated July 30, 2002 (stating that "[i]n total, the transaction is valued at \$340 million, net of the application of approximately \$20 million in excess cash at NCS."). Delaware courts customarily accept fees in the range of 3-4% of deal value and have gone as high as 5%. *See, e.g.*, Matador Capital Mgmt Corp. v. BRC Holdings, Inc., 729 A2d 280 (1998) (approving a termination fee at approximately 5% of deal value).

<sup>&</sup>lt;sup>30</sup> The must-submit covenant took advantage of the General Assembly's 1998 amendments to Delaware General Corporation Law §251(c), providing that a target board could submit a transaction proposals to shareholder without a positive recommendation. *See* DEL.CODE ANN. TIT. 8, §251(c) (2002) ("The terms of the [merger] agreement may require that the agreement be submitted to the stockholders whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the shareholders reject it.").

<sup>&</sup>lt;sup>31</sup> NCS. at \*26-27.

provisions worked in tandem to guarantee the success of the NCS-Genesis transaction. If a premium bid came along, the NCS board could change its recommendation, but it would still have to submit the Genesis transaction to a shareholder vote, the outcome of which, thanks to the voting agreements, was assured. The deal, in other words, was done upon the signing of the merger agreement. Or so it seemed.

Soon after the execution of the NCS-Genesis merger agreement, Omnicare lobbed in a transaction proposal offering a significant premium over the Genesis deal.<sup>32</sup> As a result, the NCS board withdrew its recommendation in favor of the Genesis transaction, but this, the board explained to its shareholders, was all it could do.<sup>33</sup> The Genesis deal would happen anyway:

Notwithstanding [the withdrawal of the board's recommendation], the NCS independent committee and the NCS board of directors recognize that (1) the existing contractual obligations to Genesis currently prevent NCS from accepting the Omnicare irrevocable merger proposal; and (2) the existence of [certain] voting agreements ... ensure NCS stockholder approval of the Genesis merger. <sup>34</sup>

Having committed itself to the Genesis transaction, there was simply nothing the board could do to stop it.

Omnicare, however, could do something more. It sued in the Delaware Court of Chancery, claiming that the NCS board breached fiduciary duties in committing itself to the NCS-Genesis transaction notwithstanding the emergence of subsequent superior offers.

<sup>&</sup>lt;sup>32</sup> *Id.*, at \*29-30.

<sup>&</sup>lt;sup>33</sup> In its filings with the Securities and Exchange Commission, NCS stated that: "the NCS independent committee and the NCS board of directors have determined to withdraw their recommendations of the Genesis merger agreement and recommend that the NCS stockholders vote against the approval and adoption of the Genesis merger." *Id.*, at \*30-31.

<sup>&</sup>lt;sup>34</sup> *Id.*, at \*31 (quoting SEC filings).

The Chancery Court rejected Omnicare's challenge to the NCS-Genesis transaction.<sup>35</sup> The NCS board had acted reasonably, the Chancery Court held, in large part because of the careful, unselfish process it had followed in choosing the transaction with Genesis. The court gave particular emphasis to the broad market check employed by the NCS board:

After looking for more than two years for a transaction that offered fair value to all NCS stakeholders, the board acted appropriately in approving the Genesis merger proposal, including the "deal protection" devices demanded by Genesis.<sup>36</sup>

The Chancery Court rejected the Omnicare challenge, in other words, because the company had been thoroughly shopped. Other bidders had had their chance, and now it was time to get on with it. A deal may, at some point, be done.

The Delaware Supreme Court disagreed. It reversed the Chancery Court and held that the NCS board had breached its fiduciary duties in agreeing to the must-submit covenant in the context of the voting agreements. According to the Court, "the NCS board was required to negotiate a fiduciary out clause to protect the NCS stockholders if the Genesis transaction became an inferior offer." Because there was no fiduciary out, the deal protection devices would be void and unenforceable.

#### B. Doctrinal Paradigms

<sup>35</sup> In re NCS Healthcare, Inc., Shareholders Litigation, 2002 Del. Ch. LEXIS 133 (Del. Ch., Nov. 25, 2002).

<sup>&</sup>lt;sup>36</sup> Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*54 (Del.S.Ct. Apr. 4, 2003).

<sup>&</sup>lt;sup>37</sup> NCS, at \*68. Leaving no doubt, the Court repeated this message: "The NCS board was required to contract for an effective fiduciary out clause to exercise its continuing responsibility to the minority stockholders." *Id.*, at \*71.

The legal analysis of transactions in this area has depended, historically at least, on a handful of dichotomies. First, whether the transaction involves a "change-of-control" determines the threshold level of judicial scrutiny applied to the transaction.

And second, whether the transaction is "hostile" or "friendly" may guide courts in further applications of judicial scrutiny. The NCS-Genesis transaction was a friendly acquisition not involving a change-of-control.

### 1. Change-of-Control Scrutiny

Although a director's good faith adherence to the duties of care and loyalty are expected to guide her *conduct* at all times, courts tend to interpret these duties less strictly when *reviewing* the director's actions.<sup>38</sup> The business judgment rule shields directors from judicial second-guessing for all but the most careless acts,<sup>39</sup> and courts will only consider the substantive fairness of a deal when the loyalty of directors is compromised by a conflict of interest.<sup>40</sup> As a result, most corporate transactions—such as the purchase or lease of property for the construction of a new plant or the expansion into a new line of

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<sup>&</sup>lt;sup>38</sup> See generally Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993) (distinguishing between standards of conduct, such as the duty of care, and standards of review, such as the business judgment rule).

<sup>&</sup>lt;sup>39</sup> See Dennis J. Block, Nancy E. Barton, and Stephen A. Radin, The Business Judgment Rule: Fiduciary Duties of Corporate Directors 110 (5<sup>th</sup> ed., 1998) ("a plaintiff seeking to establish a breach of the duty of care must first establish facts sufficient to overcome the business judgment rule presumption that directors acted with due care") (citing cases).

<sup>&</sup>lt;sup>40</sup> Such conflicts may exist where managers are on both sides of a transaction, acting on one side of the deal in their individual capacity, as the seller or lender, and representing the corporation on the other, as buyer or borrower. *See*, *e.g.*, DGCL §144(a) (covering transactions between the corporation and an officer or director as well as transactions in which directors and officers "have a financial interest"); Model Business Corporations Act § 8.31 (1984) (referring situations in which directors appear on both sides of a transaction as "direct" conflicts of interest). If duty of loyalty analysis is triggered, substantive review under the "entire fairness" standard requires an explicit weighing of the consideration exchanged in the transaction.

business—do not trigger enhanced judicial scrutiny, and courts generally defer to the business judgment of directors.<sup>41</sup>

Change-of-control situations, however, trigger special concerns on the part of courts. Where there is a change-of-control, courts are more likely to review the substantive consideration offered in the deal and hold directors to a standard of *immediate* shareholder welfare maximization. However, there is no requirement of immediate shareholder welfare maximization in non-change-of-control transactions, or "strategic" mergers. The Delaware Supreme Court articulated this standard over the course of three major cases: *Revlon*, <sup>42</sup> *Time Warner*, <sup>43</sup> and *QVC* <sup>44</sup>

*Revlon* involved a classic hostile takeover attempt, with Ron Perelman launching an unsolicited bid for the underperforming Revlon Corporation. After working through a series of maneuvers designed to evade Perelman, Revlon ultimately decided to pursue a

See, e.g., Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1279 (Del. 1988) (describing the "exacting standards" of entire fairness).

<sup>&</sup>lt;sup>41</sup> The examples of acquiring a new plant or line of business highlight the inadequacies of the so-called enterprise/ownership distinction, which started in the law review literature and, with NCS, has now been cited, albeit in dicta, in a Supreme Court opinion. See Bayless Manning, Reflections and Practical Tips on Life in the Boardroom After Van Gorkom, 41 BUS. LAW. 1, 5-6 (1985); E. Norman Veasey, The Defining Tension in Corporate Governance in America, 52 Bus. LAW. 393 (1997). See also Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*40 (Del.S.Ct. Apr. 4, 2003) (referring to mergers as "a shared enterprise and ownership distinction") and \*71, n.88 (noting that "merger agreements involve an ownership decision"). According to this dichotomy, enterprise decisions, such as the purchase or sale of assets and expansion or contraction of the business, are matters for the board and managers, while ownership decisions, such as mergers, require the input of shareholders. Pushing this distinction only slightly causes it to crumble. What, after all, is the basis for treating the decision to build or abandon a plant (an enterprise decision) differently from the decision to acquire or sell a company engaged in manufacturing (an ownership decision)? Moreover, if as most academic commentary on corporate law now contends, the corporation is nothing more than a nexus of contracts and shareholders are not "owners" of the corporation in any traditional sense, the sorting of corporate level issues according to ownership concerns seems wholly irrelevant. See generally Easterbrook and Fischel, The Economic Structure of Corporate Law (elaborating the nexus-of-contracts model of the corporation and applying it to particular doctrinal problem areas); G. Mitu Gulati, William A. Klein, and Eric M. Zolt, Connected Contracts, 47 UCLA L. REV. 887 (2000) (rejecting reifications of the firm in favor of a view of the firm as a collection of contracts with no a priori hierarchy, primacy, boundaries, or governance).

<sup>&</sup>lt;sup>42</sup> Revlon v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1985) (hereinafter, *Revlon*).

<sup>&</sup>lt;sup>43</sup> Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990) (hereinafter, *Time Warner*).

leveraged deal with a "white knight" acquiror, Forstmann Little, which agreed to buy Revlon and let incumbent management run it, provided that Revlon sold off some of its business divisions and remained capable of servicing its debt obligations. The Revlon board therefore agreed to the Forstmann deal in spite of the fact that Perelman had promised to beat any Forstmann offer. In this, the Delaware Supreme Court found, the Revlon board had gone too far. Because either transaction would result in the break up of the corporation, the board was required to get the best deal for its shareholders.

[I]t became apparent to all that the break-up of the company was inevitable. The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. ... The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.<sup>46</sup>

With this holding, the Delaware Supreme Court created so-called "*Revlon* duties," requiring the maximization of short term value to shareholders when the company is broken up or sold.

After *Revlon*, it took a combination of subsequent decisions to answer what triggered these special duties.<sup>47</sup> The first of these came in *Time Warner*, which can be

<sup>&</sup>lt;sup>44</sup> Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 31 (Del. 1993) (hereinafter, *QVC*).

<sup>&</sup>lt;sup>45</sup> The Delaware Supreme Court's rationale for applying enhanced scrutiny to the transaction was based upon a duty of loyalty analysis and the self-interest of the Revlon directors. One of the reasons the Revlon directors preferred the deal of "white knight" Forstmann was Forstmann's promise to restructure certain debt to relieve the Revlon directors of personal liability to the company's creditors. *See Revlon*, 506 A.2d 173, 184 ("The principal benefit went to the directors, who avoided personal liability to a class of creditors.... [W]here a significant by-product of [board] action is to protect the directors against a perceived threat of personal liability..., the action cannot withstand ... enhanced scrutiny.").

<sup>&</sup>lt;sup>46</sup> *Revlon* at 182.

<sup>&</sup>lt;sup>47</sup> See Ronald J. Gilson and Reinier Kraakman, What Triggers Revlon?, 25 WAKE FOREST L. REV. 37 (1990) (discussing various possible bases for the change of control test, all but one of which has now assumed the character of roads not taken).

read to stand for the broad proposition that "strategic" mergers do not trigger *Revlon* duties. <sup>48</sup> In *Time Warner*, Paramount launched a hostile bid for Time after Time and Warner had agreed to merge. Fearing that its shareholders would reject the Warner merger in favor of Paramount's premium offer, thus destroying "Time Culture," <sup>49</sup> Time and Warner maneuvered to protect their transaction. <sup>50</sup> When Paramount and a number of Time shareholders sued to enjoin these defensive maneuverings, the Delaware Supreme Court refused to apply *Revlon* duties. Instead, because Time had not "abandon[ed] its long-term strategy [to] seek[] an alternative transaction also involving the breakup of the company," <sup>51</sup> the Supreme Court held that the Time board was not required to maximize

Under Delaware law there are... two circumstances which may implicate Revlon duties. The first, and clearer one, is 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. However, Revlon duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction also involving the breakup of the company.

*Time Warner* at 1150. Time's negotiations with Warner thus had not triggered the requirement that it maximize short term share value by putting itself up for sale to any and all comers.

<sup>&</sup>lt;sup>48</sup> 571 A.2d 1140, 1150 (Del. 1980).

<sup>&</sup>lt;sup>49</sup> See Time Warner, at n. 4. There is good reason to be cynical of these claims. See generally RICHARD M. CLURMAN, TO THE END OF TIME: THE SEDUCTION AND CONQUEST OF A MEDIA EMPIRE 234-35 (1992) (detailing the economics of the side-deals with management that may have been the real reason for preserving "Time Culture"); Joel Edan Friedlander, Corporation and Kulturkampf: Time Culture as Illegal Fiction, 29 CONN. L. REV. 31, 39 (1996) ("At the time of its combination with Warner, Time had ceased devoting itself to uncovering the truth underlying the week's news, and it had subordinated the interests of its shareholders to the claims of the corporate body itself.").

<sup>&</sup>lt;sup>50</sup> Time's primary defensive maneuver was a restructuring of the transaction as a cash acquisition to eliminate the need for a vote by Time's shareholders. DGCL §251 requires a shareholder vote to approve a stock merger. Because the merger had been structured with a subsidiary of Time as the acquirer, only the shareholders of the subsidiary—that is, Time itself, not Time's shareholders—were required to approve the transaction under Delaware law. However, New York Stock Exchange rules require companies issuing over 20% of their voting equity in connection with a transaction to obtain shareholder approval. *See* New York Stock Exchange Listed Company Manual, Listing Standard 312.03(c). Because Time was to issue over 20% of its equity, it would be required to obtain shareholder approval pursuant to the NYSE rules. Structured as a cash acquisition, however, the NYSE rules would not apply. Thus, by restructuring the transaction as a purchase for cash of Warner by Time, the requirement of a vote by Time's shareholders was effectively eliminated.

<sup>&</sup>lt;sup>51</sup> *Time Warner* at 1150. The Supreme Court noted the circumstances under which *Revlon* generally applied:

the consideration paid in the deal.<sup>52</sup> It could continue to follow its long term plans and, when those plans included a "synergistic" merger, was not required to abandon them in order to chase after short term returns.

Previously, in the Chancery Court's consideration of the issue, Chancellor Allen had reached the same conclusion—that Time was not required to accept Paramount's offer—but had rested his decision on different grounds, namely that control had not shifted because Time was diffusely held before the deal and would be diffusely held after the deal.<sup>53</sup> Control of Time did not change, in other words, because control remained in the market:

If the appropriate inquiry is whether a change in control is contemplated, the answer must be sought in the specific circumstances surrounding the transaction. Surely under some circumstances a stock for stock merger could reflect a transfer of corporate control. That would, for example, plainly be the case here if Warner were a private company. But where, as here, the shares of both constituent corporations are widely held, corporate control can be expected to remain unaffected by a stock for stock merger.... [N]either corporation could be said to be acquiring the other. Control of both remained in a large, fluid, changeable and changing market.<sup>54</sup>

Here... Time's responsive action to Paramount's tender offer was not aimed at "cramming down" on its shareholders a management-sponsored alternative, but rather had as its goal the carrying forward of a pre-existing transaction in an altered form. Thus, the response was reasonably related the threat.

*Id.* at 1154-55. In other words, a response will be reasonably related to the threat posed as long as it amounts to the carrying-forward of a pre-existing strategy, and a board is free to carry forward strategies other than short term value maximization provided that it is not subject to *Revlon* duties. In other words, as long as the target board is not under *Revlon* and can argue that its plan pre-dates the appearance of the unsolicited bid, *Unocal* will not force it to deal with unsolicited bidders. For further discussion of *Unocal*, see infra Part II.B.2.

This control-remains-in-the-market concept cannot be taken at face value. The market is not a sentient creature. It does not vote, it does not install managers, it does not remove

<sup>&</sup>lt;sup>52</sup> It is worth noting that Paramount asserted only a *Unocal* claim against Time, while the Time shareholders asserted, in addition, a *Revlon* claim. The Supreme Court's resolution of the *Unocal* claim, on the proportionality prong, was predicated upon its *Revlon* analysis.

<sup>&</sup>lt;sup>53</sup> Paramount Communications, Inc. v. Time, Inc., C.A. Nos. 10866, 10670, 10935 (Consolidated), 1989 Del. Ch. LEXIS 77, \*68-69 (Del. Ch. July 14, 1989, *revised* July 17, 1989) (Allen, C.).

<sup>&</sup>lt;sup>54</sup> *Id.* Professor Eisenberg has criticized this rationale:

The Supreme Court in *Time Warner* accepted Chancellor Allen's findings regarding the diffuse shareholdings of the combined company, <sup>55</sup> but it decided the case on the grounds that *Revlon* duties did not apply where there was no looming break-up of the target. <sup>56</sup> Chancellor Allen's control-in-the-market reasoning ultimately returned, however, in *Paramount Communications, Inc. v. QVC Network, Inc.*, <sup>57</sup> where it furnished the basis of what is now the test for a change-of-control.

QVC involved a bidding contest between QVC and Viacom for Paramount. Once it had agreed to merge with Viacom, Paramount protected its agreement with deal protection provisions and refused to negotiate further with QVC.<sup>58</sup> When QVC sued, asserting that Paramount had violated its fiduciary duties in refusing to negotiate, the Delaware Supreme Court held that the Paramount-Viacom merger had indeed triggered

managers and, in short, it does not have control. If shareholdings are so widely dispersed that no shareholders have control, still someone has control. We have known since Berle & Means who that someone is - management. Therefore, in any transaction involving the combination of two corporations with widely dispersed shareholdings in which one corporation's management ends up in the driver's seat, control of the other corporation has shifted.

Melvin Aron Eisenberg, *The Director's Duty of Care in Negotiated Dispositions*, 51 U. MIAMI L. REV. 579, 602 (1997).

<sup>&</sup>lt;sup>55</sup> See Time Warner at 1150 ("The Chancellor's findings of fact are supported by the record and his conclusion is correct as a matter of law.").

<sup>&</sup>lt;sup>56</sup> *Id*.

<sup>&</sup>lt;sup>57</sup> 637 A.2d 31, 34 (Del. 1993) (hereinafter *QVC* 

<sup>&</sup>lt;sup>58</sup> The deal protection provisions included a no shop provision, a termination fee, and a stock option agreement favoring Viacom. *See QVC*, at 39-40. The no shop stated that Paramount would not discuss business combinations with any third party unless (i) the third party bid was not subject to any financial contingencies and (ii) the Paramount board decided that its fiduciary duties required it to negotiate with the third party. The termination fee gave Viacom \$100 million if the deal fell through, and the stock option agreement provided that if the termination fee was triggered, Viacom would also have the option of buying 24 million shares of outstanding Paramount stock at \$69 per share, a discount from the then-current market price. The option agreement further gave Viacom the right to require Paramount to pay the difference between the \$69 and the market price for the 24 million shares instead of having to buy and then sell the shares itself. Paramount was also protected by a poison pill which it agreed to redeem in order to merge with Viacom but refused to redeem for QVC.

Revlon duties which the Paramount board violated by not dealing with QVC.<sup>59</sup> Although this was a stock-for-stock deal structurally similar to the initial Time-Warner merger, the result of the Paramount-Viacom combination would be that a single shareholder, Sumner Redstone, dominated the surviving corporation. Thus, in contrast to the entity resulting from the Time-Warner merger, which would remain diffusely held, shareholders in the new Paramount-Viacom entity would find that they were minority shareholders in a corporation dominated by one man.

In the case before us, the public stockholders (in the aggregate) currently own a majority of Paramount's voting stock. Control of the corporation is not vested in a single person, entity, or group, but vested in the fluid aggregation of unaffiliated stockholders. In the event the Paramount-Viacom transaction is consummated, the public stockholders will receive cash and a minority equity voting position in the surviving corporation. Following such consummation, there will be a controlling stockholder who will have the voting power to: (a) elect directors; (b) cause a break-up of the corporation; (c) merge it with another company; (d) cash-out the public stockholders: (e) amend the certificate of incorporation; (f) sell all or substantially all of the corporate assets; or (g) otherwise alter materially the nature of the corporation and the public stockholders' interests. Irrespective of the present Paramount Board's vision of a long-term strategic alliance with Viacom, the proposed sale of control would provide the new controlling stockholder with the power to alter that vision. <sup>60</sup>

Redstone's ability to cash out the minority shareholders at his whim and the minority's inability ever again to sell for a control premium—since Redstone alone possessed control and could sell it and keep any resulting premium for himself—caused the court to note that something "of considerable significance to the Paramount stockholders" had occurred.<sup>61</sup> Most basically, the Paramount-Viacom merger represented the last chance

<sup>&</sup>lt;sup>59</sup> *QVC*at 44 ("I n the sale of control context, the directors must focus on one primary objective--to secure the transaction offering the best value reasonably available for the stockholders--and they must exercise their fiduciary duties to further that end.") (citing *Revlon*).

<sup>&</sup>lt;sup>60</sup> Id., at 43.

<sup>&</sup>lt;sup>61</sup> *Id*.

the Paramount shareholders would ever have to be paid a control premium, and as a result, the board was under *Revlon* duties to negotiate the best deal it could get.<sup>62</sup> The logic of the *QVC*ule thus followed Chancellor Allen's reasoning in *Time Warner*: a sale that resulted in a diffusely held corporation coming under the influence of a controlling shareholder would result in a "change-of-control," triggering *Revlon* duties.

The rule that emerges from this line of cases is striking in its simplicity: enhanced judicial concern for the substantive terms of a transaction, judged in light of so-called *Revlon* duties to maximize short term shareholder consideration, is triggered by a sale of control. A sale of control involves a sale of all shares for cash, as in *Revlon*, or an exchange of shares resulting in a combined company with a majority shareholder, as in *QVC*In a stock -for-stock deal that results in the combined company being diffusely held, there is no change-of-control and, as long as the merger is undertaken as a part of the long term strategic thinking of the board, as in *Time Warner*, no duty to negotiate with other bidders. Such transactions continue to receive business judgment deference.

Although having the question of judicial scrutiny turn on whether the acquiror pays in cash or stock may seem artificial, there is a sound underlying rationale. A cash deal is the shareholders' last chance to get a good return on their investment. A stock deal, by contrast, leaves open the possibility that the company may be sold on another

Id.

<sup>&</sup>lt;sup>62</sup> The Court went on to say:

Once control has shifted, the current Paramount stockholders will have no leverage in the future to demand another control premium. As a result, the Paramount stockholders are entitled to receive, and should receive, a control premium.... [T]he Paramount directors had an obligation to take the maximum advantage of the current opportunity to realize for the stockholders the best value reasonably available.

day, and as a result, does not amount to the shareholders' last chance to be paid a control premium.

The distinction between standards of conduct and standards of review also deserves emphasis on this point. As a matter of director conduct, boards should seek to maximize shareholder welfare at all times, whether that means selling to the highest bidder or agreeing to a synergistic merger. The change-of-control paradigm does not affect these responsibilities. It does, however, alter the standard of judicial *review* applied to certain transactions. Courts will only intervene when the sale is the shareholders' last chance to maximize value.

Finally, it is worth noting that the NCS-Genesis merger agreement did not involve a change-of-control since it was a stock deal that would not result in a single control person or group after consummation of the transaction. It was not, in other words, the NCS shareholders' last chance to sell control over their investment.

## 2. Fighting Nicely: Friendly Takeovers

A "friendly" deal is negotiated with the target's board of directors. By contrast, a takeover attempt is "hostile" when the bidder submits an unsolicited offer for the company and, rather than negotiating a deal with the target directors, seeks to circumvent the intermediary role of the target board by appealing directly to target shareholders. <sup>64</sup>

<sup>64</sup> See generally 1M ARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS & FREEZEOUTS 1.01[2] (1990) ("The principal takeover approaches include a "friendly" transaction negotiated with management... a "hostile" offer made directly to target shareholders, without management approval; and, as a supplement or alternative to these approaches, large open market and/or privately negotiated purchases of target stock.").

<sup>&</sup>lt;sup>63</sup> See Eisenberg, supra note 38.

Most of the famous takeover cases of the 1980s and early 1990s as well as most of the academic commentary surrounding takeovers takes place in the arena of hostile acquisitions. Revlon, for example, centered on Ron Perelman's hostile tender offer for the Revlon corporation while *Time Warner* and *QVC* each involved hostile interference with negotiated acquisitions. The most significant case addressing hostile takeovers, however, is *Unocal v. Mesa Petroleum*, 66 which applies when target boards take certain actions regardless of whether the contemplated transaction involves a change-of-control.

In *Unocal*, notorious raider T. Boone Pickens launched an unsolicited tender offer for a seemingly underpriced oil company. In response, the incumbent board engaged in a discriminatory self-tender, excluding Pickens' shares from its buy-back proposal. Pickens sued. In evaluating the propriety of the Unocal board's response to Pickens' hostile bid, the Delaware Supreme Court famously remarked: "because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders" in responding to a hostile takeover bid, enhanced judicial scrutiny applied to the defensive actions of the target board. <sup>67</sup>

*Unocal* provided an additional trigger for heightened judicial scrutiny and ushered forth a new era in takeover jurisprudence.<sup>68</sup> The rationale for applying enhanced scrutiny

<sup>&</sup>lt;sup>65</sup> See, e.g., authors cited at supra note 14, infra notes 73-77.

<sup>&</sup>lt;sup>66</sup> 493 A.2d 946 (Del. 1985) (hereinafter *Unocal*).

<sup>&</sup>lt;sup>67</sup> *Id.*, at 954. Enhanced scrutiny under *Unocal* analyzes the proportionality of the target's response to the threat of the bid. *Id.*, at 955 ("If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.").

<sup>&</sup>lt;sup>68</sup> When it first appeared, the *Unocal* standard appeared to offer a standard of intermediate scrutiny," somewhere between entire fairness and business judgment deference. However, judicial scrutiny under Unocal has become increasingly lax, much to the chagrin of most corporate law scholars. *See* Gilson, *Unocal Fifteen Years Later, supra* note 14; Gilson & Kraakman, *Intermediate Standard, supra* note 14; Thompson & Smith, *Sacred Space, supra* note 17 *But see* Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U CHI. L. REV. 1037, 1064-66 (2002) (defending the deferential interpretation of *Unocal* against

to a target company's reaction to hostile takeover offers rested on an intuition regarding the self-interest of incumbent target directors: When a target is taken over, its board of directors is generally replaced. Incumbent directors thus have strong incentives, based in their own self-interest, to resist unsolicited takeover bids notwithstanding the best interests of the corporation and its shareholders. <sup>69</sup> Such self-serving motivations are bad for shareholders. Most obviously, a decision motivated by entrenchment to block a takeover prevents shareholders from receiving premium offers for their shares, and slightly more subtly, it harms shareholders by impeding the efficient allocation of resources and muting the disciplinary effects of the market for corporate control. <sup>70</sup> Enhanced scrutiny is therefore appropriate to protect shareholder welfare against the self-preservative instincts of directors and managers.

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its critics on the basis that the decision to accept or reject a takeover is properly up to the target's board of directors).

<sup>&</sup>lt;sup>69</sup> See William T. Allen, Jack B. Jacobs, and Leo E. Strine, Jr., Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 26 DEL. J. CORP. L. 859, 862-63 (2001) (discussing "cases where the directors have no direct pecuniary interest in the transaction but have an 'entrenchment' interest, i.e., an interest in protecting their existing control of the corporation" and noting that "the corporation law has always been concerned ... with whether directors have acted to advance their personal self-interest by entrenching themselves in office"); Ronald J. Gilson, Lipton and Rowe's Apologia for Delaware: A Short Reply, 27 DEL. J. CORP. L. 37, 41 (2002) ("Target management's efforts to block a takeover may reflect a good faith effort to secure a better price for shareholders, or it may reflect entrenchment--a preference of target management to maintain the status quo.").

The market for corporate control directly limits the ability of managers and directors to usurp shareholder welfare by forcing out those who do not manage the corporation loyally and efficiently. According to the theory, a corporation that is managed foolishly or selfishly will be taken over by more efficient managers who will themselves be constrained in their ability to behave foolishly or selfishly by the presence of other would-be management teams ready to launch their own takeover bid should the company again falter. *See generally* Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110, 112 (1965) [hereinafter, Manne, *Mergers*]; John Coffee, *Shareholders versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1 (1986); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1164 (1981), Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 6 (1983) (stating that the market for corporate control "limits management's divergence from shareholder wealth maximization").

In other words, selfishly entrenched management is the omnipresent specter haunting the world of hostile takeovers, and the standard of enhanced scrutiny announced in *Unocal* was designed to protect shareholder welfare by controlling this threat.<sup>71</sup> Friendly acquisitions, in contrast, do not have such ghosts.

Because friendly deals are the products of a negotiation between the incumbent board and the would-be acquiror, entrenchment is a less serious concern. The very act of negotiation signals that the target board is open to the possibility of its replacement or, at least, reshuffling upon consummation of the transaction. By agreeing to its own replacement, the board shows that it is not immune to the pressures of the market for corporate control and opens the way for shareholders to be paid a premium for their shares. On a slightly more abstract level, the board promotes allocative efficiency by enabling the assets it manages to be transferred to a user that values them more highly.

Of course, a director who is willing to negotiate towards a corporate future that does not include herself may seek to get some personal benefit out of the negotiation, thus diverting some portion of the overall increase in wealth from shareholders to her own bank account.<sup>72</sup> Overall, however, this is likely to be a smaller loss than if the director, acting with others, blocks the transaction. Side payments to incumbent managers in connection with a takeover divert a *portion* of shareholder welfare, whereas

<sup>71</sup> Whether the *Unocal* standard effectively polices this frontier is, of course, another matter. *See generally* Gilson, *Unocal Fifteen Years Later, supra* note 14, at 499 (noting that "the supreme court's effort to articulate the Unocal standard... collapses into an unexplained functional preference that changes of control should occur through elections rather than courts"); Thompson & Smith, *Sacred Space, supra* note 17, at 284-286 (2002) (reporting empirical findings that very few Chancery or Supreme Court decisions have invalidated director action under the *Unocal* standard).

<sup>&</sup>lt;sup>72</sup> As they near the end of their tenure with the target company, directors may look out for themselves by securing a position for themselves in the combined company, seeking "consulting" arrangements, or engaging in other forms of side deals. *See infra* notes XX-XX and accompanying text (describing the incentives of directors and managers in their final period of employment with a target company).

blocking the takeover altogether eliminates *any* potential increase in shareholder welfare. Support for this common sense intuition can be found in the recent work of Professors Kahan and Rock focusing on corporations' "adaptive responses" to takeover law. Their argument notes that although side payments such as change-in-control compensation plans may divert payments away from shareholders, on the whole the welfare of shareholders is improved because these mechanisms render boards and management more receptive to wealth-enhancing takeovers. Similarly, despite the fact that self-interested directors and managers may seek side payments in friendly deals, the welfare loss to shareholders of such activities is likely to be considerably less than that caused by directors and managers who seek, instead, to block hostile deals. To mix

For buyers, ... [p]ayments owed managers under incentive compensation contracts can be budgeted into the price; the amounts, while large for CEOs, are of the same order of magnitude as investment banking fees and amount to a relatively small percentage of the deal price; and market participants generally assert that deals that make economic sense get done.

For target shareholders, the current state likewise seems satisfactory: Managers have largely adopted "shareholder value maximization" as their mantra; target shareholders earn significant premia in friendly deals; and the market through the 1990s soared.

Id., at 899. See also Jennifer Arlen, Designing Mechanisms to Govern Takeover Defenses: Private Contracting, Legal Intervention, and Unforeseen Contingencies, 69 U. CHI. L. REV. 917, 920 (2002) (arguing that Kahan and Rock's findings regarding adaptive mechanisms do not necessarily alleviate the pressure to improve takeover law, which often "leaves shareholders vulnerable to unpredictable strategic board action, in ways the parties cannot adequately redress through private arrangements"); Reinier Kraakman, The Best of All Possible Worlds (or Pretty Darn Close), 69 U. CHI. L. REV. 933, 934 (2002) (discussing Kahan and Rock's thesis and predicting that empirical findings will support "a positive relationship between management's decision to sell a company and the size of its payout in the event of a sale").

<sup>&</sup>lt;sup>73</sup> See Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett, 19 CARDOZO L. REV. 511, 551 (1997) (arguing that ability of boards to resist takeovers ad infinitum "would have a devastating impact on the control market and, ultimately, would have large scale economic effects").

<sup>&</sup>lt;sup>74</sup> Adaptive responses of corporations to anti-takeover law include mechanisms to align the incentives of directors and managers with shareholders, including independent boards, severance packages, option compensation, and similar mechanisms designed to incline boards favorably towards takeover offers. *See* Marcel Kahan and Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. Chi. L. Rev. 871 (2002).

<sup>&</sup>lt;sup>75</sup> See id., at 899:

metaphors: in the context of friendly acquisitions, target directors do not insist on going down with the ship that they themselves have wrecked. Instead, they call for help and paddle away with what they can carry, increasing the odds that the ship's other passengers, the shareholders, may be rescued.

Although the neat categorization of takeovers into "hostile" or "friendly" deals makes sense as an abstraction, the above account may be vulnerable to the objection that there is little distinction between the two as a practical matter. Moreover, the effectiveness of the hostile tender offer as an acquisition tactic has been severely damaged by the invention of the poison pill and effectively destroyed through the combination of a poison pill with a staggered board. Due to the strength of the antitakeover defenses available to corporate boards, the vast majority of all deals are now friendly, if in name only, since well-advised companies can no longer be taken over by appealing directly to their shareholders. Because all deals must now be negotiated with the target board and boards appear to have the legal authority to "just say no" to acquisition offers while remaining invulnerable behind their anti-takeover defenses.

<sup>&</sup>lt;sup>76</sup> See, e.g., G. William Schwert, *Hostility in Takeovers: In the Eyes of the Beholder?*, 55 J. Fin. 2599 (2000) (arguing that there is no meaningful economic distinction between hostile and friendly deals); but see Randall Morck, Andrei Shleiffer, and Robert W. Vishny, *Characteristics of Hostile and Friendly Takeovers*, in ALAN J. AUERBACH, ED., CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 101 (1988) (supporting a distinction between "disciplinary" hostile takeovers and "synergistic" friendly acquisitions).

<sup>&</sup>lt;sup>77</sup> A corporation with a poison pill but without a staggered board of directors can be taken over via the proxy-fight mechanism. The combination of the staggered board, which delays and effectively defeats the proxy fight as a takeover mechanism, with a poison pill, which defeats a hostile tender offer, thus renders a corporation more or less takeover proof. *See generally* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 893-925 (2002) (explaining the effectiveness of staggered boards as an anti-takeover device).

<sup>&</sup>lt;sup>78</sup> See Joseph H. Flom, Mergers & Acquisitions: The Decade in Review, 54 U. MIAMI L. REV. 753, 761-62 (2000).

<sup>&</sup>lt;sup>79</sup> See generally Moore Corp. v. Wallace Computer Servs., Inc., 907 F. Supp. 1545 (D.Del. 1995) (federal court applying Delaware law to allow a board to remain independent after receiving and rejecting a takeover offer); *Time Warner*, 571 A.2d 1140 (Del. 1990) (permitting the Time to retain its poison pill and

self-interested entrenchment may indeed be a pervasive problem, regardless of whether a hostile takeover contest has been initiated. <sup>80</sup> If entrenchment is thus viewed as a pervasive problem—potentially present whether or not a firm becomes the subject of a takeover attempt—then the policy basis for distinguishing hostile and friendly bids seems to fade. Entrenchment again seems omnipresent.

Nevertheless, the Delaware courts have been reluctant to adopt a rule, apart from the basic duties of care and loyalty, that combats entrenchment as a *general* matter.<sup>81</sup> Instead, Delaware courts have sought to control the threat of entrenchment in specific contexts. Courts scrutinize entrenchment under *Unocal* when boards *respond* to defend themselves from the threat of a hostile bid.<sup>82</sup>

reject Paramount's hostile bid). *But see* Gordon, *supra* note 73 (criticizing a rule that would allow a board to say no indefinitely).

<sup>&</sup>lt;sup>80</sup> That a company has not become the target of an acquisition attempt should not be taken to imply that entrenchment is not a problem for that company since bidders are not likely to waste time and resources on futile efforts to oust unreceptive and well-protected boards. Moreover, boards may seek negotiated acquisitions in order to avoid becoming hostile targets. *See* Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 372 n.208 (1987) (hereinafter Johnson & Siegel, *Mergers*) (noting that "there is no bright line separating defensive mergers, such as the merger evaluated in *Revlon*, from uncoerced combinations, given that even the threat of a hostile takeover may compel target management to consider a negotiated transaction").

Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002) (arguing that once "undistorted" shareholder choice is ensured, boards should not have veto power over takeover bids); Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) (opposing board veto, but arguing in favor of anti-takeover devices that provided management with time to solicit competing offers). *But see* Jennifer Arlen and Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, \_\_\_P ENN. L. REV. \_\_\_ (forthcoming) [at 4] (arguing that permitting board discretion through anti-takeover devices in ordinary business decisions since "the allocation of control rights over defensive tactics not only affects the firm after a tender offer is announced, but also may affect how managers manage the firm ex ante").

<sup>&</sup>lt;sup>82</sup> Williams v. Geier, 671 A.2d 1368, 1377 (Del. 1996) ("A Unocal analysis should be used only when a board unilaterally ... adopts defensive measures in reaction to a perceived threat."). The exception that proves this rule is Moran v. Household International, Inc., 500 A2d 1346 (Del. 1985) [hereinafter *Moran*]. In *Moran*, the Delaware Supreme Court stated that *Unocal* was applicable to a board's prophylactic adoption of defensive provisions (a poison pill). *Id.*, at 1356. In spite of this judicial pronouncement, the actual holding in *Moran*, which upholds the adoption of a poison pill, seems to rest on a combination of statutory authority and the business judgment rule, rendering the Court's assertion that *Unocal* applies a mere dictum. *Id.*, at 1350-55. Furthermore, the subsequent development of Delaware takeover

But friendly deals, under normal circumstances, should not be thought to *respond* to anything other than the long term business or financial concerns of the corporation. Although a negotiated acquisition may occasionally be used as a defensive device to ward off a hostile bid—this is the standard "white knight" defense which Revlon, for example, sought to employ in its deal with Forstmann Little<sup>83</sup>—apart from such "defensive mergers," friendly deals are generally not defensive responses. Although Delaware courts have been solicitous of board actions in connection with defensive mergers, at least prior to *NCS*, courts had generally not voiced entrenchment concerns in the context of a purely non-reactive friendly deal. 86

jurisprudence evaluates anti-takeover provisions when deployed rather than when adopted. *See* cases cited at *supra* note 79 (upholding board decisions not to remove their takeover defenses under *Unocal* scrutiny). Thus, although there is some precedent for evaluating defensive provisions in the absence of a takeover contest, this line of cases suggests that judicial analysis of such provisions is rare indeed. The role of *Moran* might best be understood as leaving room for courts to evaluate the sudden adoption of a defensive provision, such as the "no hand" pill in *Quickturn*, which amounts to a negative commitment strategy, preserving management entrenchment into the foreseeable future. *See infra* notes 138-145 and accompanying text (discussing *Quickturn* as adopting a rule against *negative* precommitment). The actions of the board in *NCS*, by contrast, are not obviously captured by *Moran* since they amount to the continuation of the affirmative act of agreeing to a deal, not a purely negative refusal to negotiate. In this way, the provisions in *NCS* may not even count as "defensive" for purposes of applying *Unocal* scrutiny and therefore irrelevant under *Moran*.

<sup>&</sup>lt;sup>83</sup> See supra TAN & note 45.

<sup>&</sup>lt;sup>84</sup> See Wayne O. Hanewicz, When Silence is Golden: Why the Business Judgment Rule Should Apply to No-Shops in Stock-for-Stock Merger Agreements, 28 J. CORP. L. 205, 233-37 (2003) (hereinafter Hanewicz, Golden) (arguing that "Unocal should not be applied to no-shops unless they are part of a defensive merger").

<sup>85</sup> Other commentators writing about lock-up provisions have emphasized this distinction. See Stephen M. Bainbridge, Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions, 75 MINN. L. REV. 239, 289, 327-32 (1990) [hereinafter Bainbridge, Exclusive Merger Agreements] (arguing that courts should only invalidate preclusive lockups when target management has refused to solicit competing bids); Marcel Kahan & Michael Klausner, Lockups and the Market for Corporate Control, 48 STAN. L. REV. 1539, 1564-1570 (1996) (arguing that lockups granted after a hostile bid is made or when one is anticipated should be subjected to strict scrutiny, but lockups granted in friendly deals, when there are no other indicia of self-dealing in the deal, should be analyzed under the business judgment rule); David A. Skeel, Jr., A Reliance Damages Approach to Corporate Lockups, 90 Nw. U. L. REV. 564, 595-600 (1995) (arguing that the principle function of lockups is to award reliance damages and that therefore business judgment rule analysis ought generally to apply).

<sup>&</sup>lt;sup>86</sup> Vice Chancellor Strine's opinion in *ACE* may be viewed as an exception to this principle. *See* ACE Ltd. v. Capital Re Corp., 747 A.2d 95, 105 (Del. Ch., Oct. 28, 1999) (hereinafter, *ACE*) (finding that a friendly merger not involving a change-of-control "implicates many of the same policy concerns" as a change-of-

Thus, in spite of the limitations of the "friendly" versus "hostile" dichotomy at its limits, there is a large space for easy cases where the distinction still makes sense. Non-reactive friendly deals do not raise the same entrenchment concerns as defensive mergers designed in response to a hostile bid. Moreover, *NCS* was one of the easy cases, with an apparently selfless target board seeking to negotiate the best deal for its shareholders with no interest in defending itself from ouster. Even in the close cases, however, where target boards seem to favor one bid over another for selfish reasons, the market-check proposal outlined in Part V below provides a simple structural solution to the risk that directors may behave in a self-serving manner.<sup>87</sup>

But that is yet to come. At this point in the argument, it is only necessary to note the imperfect categorization of deals as "friendly" or "hostile," to point out that the policy rationale for enhanced judicial scrutiny is more obviously applicable to hostile deals and that, as a result, Delaware courts have previously only applied heightened scrutiny to friendly deals that are defensive or reactive to a hostile bid that has either been made or that appears to be on the horizon. Finally, it bears mentioning that whatever confusion may exist between the categories of hostile and friendly at the margins, the NCS-Genesis merger agreement was unquestionably a friendly, non-reactive deal.

#### III. Doctrinal Foundations

control transaction). But *ACE* is arguably inconsistent with prior law in the same way as *NCS*. *See infra* TAN and notes 189-197 (discussing the holding and doctrinal implications of *ACE*).

<sup>&</sup>lt;sup>87</sup> See infra TAN and notes XX-XX.

The *NCS* majority claimed to arrive at its bright line rule mandating fiduciary outs in friendly merger agreements through a consideration of existing Delaware law, invoking two alternative sources of doctrine to support its holding. First, the three Justice majority argued that the actions taken by the NCS board required enhanced scrutiny under  $Unocal^{88}$  and that the application of enhanced scrutiny triggered the invalidation of the provisions protecting the NCS-Genesis merger agreement. Second, the majority cited QVCor the principle that a board may not "disable" itself from carrying out its fiduciary duties. <sup>89</sup> In order for deal protection provisions not to be unreasonable under Unocal or disabling under QVChe Court reasoned, target boards must retain an effective termination right.

However, close analysis of the arguments and authority cited in support of the majority opinion reveals that the holding rests on an infirm doctrinal foundation. In fact, neither Unocal nor QV frovide appropriate support for the rule in NCS.

## A. The Majority's First Doctrinal Basis: Reasonableness and *Unocal*

Unocal "reasonableness" looks to the proportionality of a board's response to the threat to corporate policy embodied by the takeover bid. <sup>90</sup> In NCS, the Delaware Supreme Court applied the Unitrin version of the proportionality test: a response may fall within the acceptable "range of reasonable responses" only if it passes the threshold test

<sup>88</sup> Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (hereinafter *Unocal*).

<sup>&</sup>lt;sup>89</sup> Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 31 (Del. 1993) (hereinafter QVC).

<sup>&</sup>lt;sup>90</sup> *Unocal*, 493 A.2d 946, at 955 ("If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.").

of being neither "preclusive" nor "coercive." In evaluating the reasonableness of the deal protections agreed to by the NCS board, 92 the Court glommed the must-submit covenant together with the voting agreements as "inextricably intertwined," providing Genesis with "a complete defense" against intervening bidders. 93 This step in the analysis was outcome determinative since the packaging of these particular deal protections effectively guaranteed the closing of the NCS-Genesis transaction. Because the certain closing of one deal plainly *precludes* other deals, and rendering shareholders unable to stop the transaction arguably *coerces* them, the Court could easily find the NCS-Genesis deal protections unreasonable and unenforceable under *Unocal*. 94

Notwithstanding the logic of this analysis, the basic policy question remains: is *Unocal* scrutiny appropriate?

The majority needed some form of enhanced scrutiny as a lever to overcome the deference accorded to director action under the business judgment rule. <sup>95</sup> *Revlon* duties to maximize short term consideration plainly did not apply since the NCS-Genesis transaction was a stock-for-stock merger not involving a change-of-control. <sup>96</sup> In "normal"

The deal protection devices adopted by the NCS board were designed to coerce the consummation of the Genesis merger and preclude the consideration of any superior transaction. The NCS directors' defensive devices are not within a reasonable range of responses to the perceived threat of losing the Genesis offer because they are preclusive and coercive.

Id.

<sup>&</sup>lt;sup>91</sup> NCS, at \*58, 61. See also Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387-88 (Del. 1995).

 $<sup>^{92}</sup>$  The Court defined the threat—the first stage of *Unocal* analysis—as the possibility that the Genesis deal would be lost, leaving NCS with nothing. *NCS*, at \*57.

<sup>&</sup>lt;sup>93</sup> *Id.*, at \*55.

<sup>&</sup>lt;sup>94</sup> *Id.*, at \*61. In the words of the Court:

<sup>&</sup>lt;sup>95</sup> See supra Part II.B. (describing the triggers of enhanced scrutiny and their relationship to ordinary business judgment deference).

<sup>&</sup>lt;sup>96</sup> See supra Part II.B.1. Were they applicable, *Revlon* duties mandating short term shareholder welfare maximization might appear to require NCS to scrap the Genesis deal and pursue the Omnicare bid.

circumstances," the Court conceded, it would defer to the business judgment of directors; only in "certain circumstances" would courts be willing to review the reasonableness of board action. <sup>97</sup> *Unocal* illustrated "one of those circumstances," and so too, the majority asserted, did *NCS*. <sup>98</sup> Applying the famous language of *Unocal* as the basis for enhanced scrutiny in *NCS*, the majority cited the "omnipresent specter of director self-interest whenever a board adopts defensive devices to protect a merger agreement." But are the situations in *Unocal* and *NCS* really parallel?

As discussed above, <sup>100</sup> *Unocal* involved a hostile takeover attempt. The specter haunting the takeover context is entrenchment—that is, the possibility that incumbent directors will resist a wealth-enhancing takeover because it is also likely to result in their ouster. The anti-takeover maneuverings of the Unocal board were a *response* designed to *block* Pickens' offer. <sup>101</sup>

*NCS*, on the other hand, involved a friendly merger negotiation. The NCS board desperately sought a transaction and agreed to the best one it could find. Entrenchment was not a possibility. The company would either be sold, or it would drift towards

However, even in *Revlon* situations, courts have held that a target board may declare a sale final and bind itself to a no-out deal provided that it has acted in good faith to maximize shareholder consideration. See, e.g., Renaissance Communications Corp. v. Nat'l Broad. Corp., Inc., C.A. No. 14446, 1995 WL 1798510, (Del. Ch. Aug. 1, 1995) (Allen, C.) (suggesting that strong deal protections would be permitted after an auction had been conducted on the basis); Rand v. W. Air Lines, C.A. No. 8632, 1994 Del. Ch. LEXIS 26 (Del. Ch. Feb. 25, 1994) (Berger, V.C.) *aff'd* 659 A.2d 228 (Del. 1995) (approving a stock option agreement that "foreclosed other bidding" on the grounds that the company had been thoroughly shopped and the deal protection device provided a means of pursuing the best option then available).

<sup>&</sup>lt;sup>97</sup> *Id.*, at \*34.

<sup>&</sup>lt;sup>98</sup> *Id.*, at \*35.

<sup>&</sup>lt;sup>99</sup> *Id.*, at \*41 (citing Unocal).

<sup>&</sup>lt;sup>100</sup> See supra Part II.B.2.

<sup>&</sup>lt;sup>101</sup> See supra TAN XX.

bankruptcy, either of which would displace incumbent management. Rather than responding to block an unwanted offer, the deal protection devices embedded in the NCS-Genesis agreement were designed to *ensure the completion* of a *previously negotiated* transaction. The specter of entrenchment does not seem to have been present in *NCS*.

The policy rationale underlying the application of the *Unocal* proportionality test to hostile takeovers, in other words, does not apply with equal strength to the friendly deal protections at issue in *NCS*. Unfortunately, rather than providing a reasoned foundation for the application of enhanced scrutiny to friendly merger agreements, the majority in *NCS* rested its use of *Unocal* scrutiny on a facile analogy between deal protections in friendly merger agreements and defensive actions in hostile takeover contests. Referring to anti-takeover provisions at several points in its reasoning, <sup>103</sup> the Court ultimately announced that it would treat the phrase "defensive devices" as synonymous with "deal protection devices." This treatment may accord with common sense since deal protection provisions are plainly intended to *defend* the initial merger agreement from unwanted interference. However, treating deal protections as "defensive devices" has an additional legal meaning: it triggers enhanced scrutiny under *Unocal*. <sup>105</sup>

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<sup>&</sup>lt;sup>102</sup> See Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991) (noting that management teams tend to be displaced in bankruptcy).

<sup>&</sup>lt;sup>103</sup> See, e.g., Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*47 (Del.S.Ct. Apr. 4, 2003) ("A board's decision to protect its decision to enter a merger agreement with defensive devices against uninvited competing transactions that may emerge is analogous to a board's decision to protect against dangers to corporate policy and effectiveness when it adopts defensive measures in a hostile takeover contest."), and \*48 (after noting that a board may not defeat a takeover with draconian means: "[s]imilarly, ... a board does not have unbridled discretion to defeat any perceived threat to a merger by protecting it with any draconian means available").

<sup>&</sup>lt;sup>104</sup> NCS, at \*53.

<sup>&</sup>lt;sup>105</sup> The Court cites *Unitrin* on this point, emphasizing that a strong defensive measure may fail the *Unocal* test and be invalidated as "draconian." *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387 (Del.

By identifying deal protections as defensive, the Court establishes *Unocal* review by definition.

The only authority cited by the Court for applying *Unocal* scrutiny to deal protection provisions is *Time Warner*, where the Court stated, in dicta, that deal protection devices "are properly subject to *Unocal* analysis." Notwithstanding the questionable authority of a statement made in dicta, upon closer inspection, *Time Warner* does not support the application of *Unocal* scrutiny to deal protection provisions in friendly mergers.

In *Time Warner*, the Court recognized that in the context of a friendly merger agreement, deal protection provisions are merely a means of accomplishing a board's strategic objectives—that is, a merger with a particular partner—rather than a defensive reaction. Because the board has broad authority to pursue these objectives in their business judgment, the Court reasoned, actions taken to accomplish such ends should

<sup>1995) (&</sup>quot;this Court has consistently recognized that defensive measures which are either preclusive or coercive are included within the common law definition of draconian") (quoted in *NCS*). Commentators have argued that deal protection provisions are inherently defensive, triggering *Unocal* scrutiny. *See, e.g.,* Mark Lebovitch and Peter B. Morrison, *Calling a Duck a Duck: Determining the Validity of Deal Protection Provisions in Merger of Equals Transactions,* 2001 COLUM. BUS. L. REV. 1, 14 (2001) (hereinafter Lebovitch and Morrison, *Duck*) (arguing that deal protection provisions should trigger *Unocal* scrutiny because they are "defensive"); Strine, *supra* note 11, at 930 (predicting that "practitioners looking for reasonable certainty might do better under a regime that requires courts to apply the *Unocal* standard to deal protection measures").

<sup>&</sup>lt;sup>106</sup> Paramount Communications v. Time, 571 A.2d 1140, 1151 (Del. 1980) (quoted, with additional emphasis, in *NCS*, at \*42). The *NCS* Court improperly characterizes this statement as a "holding" of the *Time Warner* Court. *NCS*, at \*42. The *Time Warner* Court's statement regarding the application of *Unocal* to deal protection devices is technically dicta because it was not necessary to reach the conclusion of the issue under consideration—that is, whether the adoption of deal protection devices outside of the context of a change of control triggers *Revlon* duties. The *Time Warner* Court held that *Revlon* was not triggered and appended to its analysis on this point the suggestion that *Unocal* would be an appropriate standard of review for such provisions. The actual *Unocal* analysis of these provisions, however, was not properly before the Court, and the Court did not itself engage in any *Unocal* analysis of deal protection provisions. *See Time Warner*, at 1151, n. 15 (noting that "the legality of the various safety devices adopted to protect the original agreement is not a central issue").

<sup>&</sup>lt;sup>107</sup> See id., at 1150-51.

likewise be accorded the deference of the business judgment rule. <sup>108</sup> This is the cryptic message of the Court in footnote 15, which endorsed the findings and reasoning of Chancellor Allen below that "the court found that [the deal protection devices] *predated* any takeover threat ... and had been adopted for a *rational business purpose*: to deter Time and Warner from being 'put in play' by their March 4 Agreement." <sup>109</sup> Because "rational business purpose" is the standard of the business judgment rule, the recitation of this phrase implies that deal protection provisions adopted outside of the context of a hostile takeover fight will be accorded business judgment deference. In addition, by emphasizing that the deal protections "predated"—that is, amounted to a continuation of an existing strategy rather than a short-term defensive response—the quoted language provides a further basis for limiting the application of *Unocal* to responsive defenses and not applying it to pre-existing board strategies. Footnote 15, in other words, strongly suggests that deal protection provisions in friendly mergers not involving a change-of-control ought to receive business judgment deference rather than *Unocal* scrutiny. <sup>110</sup>

By invoking *Time Warner* to support the application of *Unocal* to deal protections, the *NCS* Court obliged itself to confront these implications of footnote 15. It did so by asserting that the note supports Chancellor Allen's application of "*Unocal* analysis to each of the structural devices contained in the original merger agreement between Time and Warner." This statement mischaracterizes Chancellor Allen's opinion. The Chancery Court did not, in fact, apply *Unocal* to each of the deal protection

<sup>&</sup>lt;sup>108</sup> *Id*.

<sup>&</sup>lt;sup>109</sup> *Id.*, at 1151, n. 15 (emphasis added). The deal protection provisions, or "structural safety devices," referred to by the Court were contained in the parties' Share Exchange Agreement.

<sup>&</sup>lt;sup>110</sup> *Id*.

<sup>&</sup>lt;sup>111</sup> NCS, at \*43.

provisions in the *original* merger agreement. It analyzed those provisions only in terms of *Revlon* duties and the change-of-control paradigm. Rather, the Chancery opinion applied *Unocal* to the restructuring of the Time-Warner transaction *as a whole*. That is, the Chancery opinion invoked *Unocal* to analyze the transaction only when it was *restructured* in *response* to Paramount's *hostile* bid. In no way did the Chancellor's opinion speak to the issue of deal protections in *friendly* merger agreements that are *non-reactive*—that is, not undertaken merely to defend the target from the advances of an unwanted bidder. The *NCS* Court's reading of *Time Warner* footnote 15 is thus either misguided or insincere. Because footnote 15 emphasizes rational business purpose—that is, the review standard of the business judgment rule—it supports business judgment deference for deal protection devices not adopted in response to a hostile bid.

In addition to the concededly ambiguous message of *Time Warner*, there is additional authority weighing against the application of *Unocal* scrutiny to this particular set of deal protections. In *Williams v. Geier*, the Court upheld a defensive recapitalization plan under the business judgment standard because a majority of shareholders had approved it. Enhanced scrutiny was not appropriate, the Court noted, because "*Unocal* analysis should be used only when a board unilaterally (i.e., without

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<sup>&</sup>lt;sup>112</sup> See Paramount Communications, Inc. v. Time, Inc., 1989 Del. Ch. LEXIS 77, at \*63-69 (Del. Ch. Jul. 14, 1989). See also supra Part II.B.1. (discussing the change-of-control paradigm).

<sup>&</sup>lt;sup>113</sup> See id., at \*78-88. The transaction in *Time Warner* was restructured from a stock acquisition of Time by Warner to a mixed stock and cash acquisition of Warner by Time in order to avoid complications that would have been introduced by the vote of Time shareholders.

<sup>&</sup>lt;sup>114</sup> Each of the dissenting opinions in *NCS* emphasizes this point. *See* Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*83, n.102 (Del.S.Ct. Apr. 4, 2003) (Veasey, dissenting) and \*105-106 (Steele, dissenting).

<sup>115 671</sup> A.2d 1368 (1996).

stockholder approval) adopts defensive measures...." Because the shareholders approved the recapitalization, there was no unilateral defensive action by the board and the business judgment rule applied.

Similarly, the defensive devices in *NCS* did not involve unilateral board action. Although the board agreed to the must-submit covenant, the majority shareholder voting agreements were the result of shareholder action. If, as the Court insists, the two provisions are to be treated together, they ought to be understood as defensive action taken by the board *with majority shareholder approval*. In other words, the majority shareholder voting agreements should be seen to operate as majority shareholder ratification of the devices protecting the NCS-Genesis transaction. The analogy to *Williams* thus supports business judgment deference for any deal protection device with majority voting agreements.

Alternately and at the very least, *Williams* shows that *Unocal* cannot apply to the voting agreement itself which plainly, as an agreement of a majority of the NCS shareholders, had shareholder approval. This suggests that the voting agreement should be severed from the must-submit clause in the court's analysis. Once the must-submit clause is viewed in isolation, it will pass any scrutiny under *Unocal* since, by itself, it is absolutely powerless to prevent an overbid and therefore harmless to target shareholders. Once severed from the voting agreement, the must-submit clause has no preclusive or coercive effect.

The Court rejected the precedental value of *Williams*, however, on the grounds that *Williams* did not hold that enhanced scrutiny could not be applied to "a

<sup>&</sup>lt;sup>116</sup> *Id.* at 1377.

comprehensive and combined merger defense plan." <sup>117</sup> Maybe so, but this one sentence rejection of *Williams* fails to distinguish the reasoning underlying that holding from the situation at hand in *NCS*, just as the Court had failed to analyze the differences between defensive devices and anti-takeover provisions and the differences between friendly mergers and hostile takeovers.

In sum, the application of *Unocal* to the deal protection devices in *NCS*, and to deal protection devices generally, is deeply unsatisfactory. <sup>118</sup> *Unocal* involved a specific context—hostile takeovers—and a specific risk—entrenchment. While the specter of self-interest may be omnipresent, the risk of entrenchment is not. There is much less entrenchment risk in friendly mergers. In such cases, there should at least be some basis for suspecting self-interest on the part of the target board before applying enhanced scrutiny. <sup>119</sup> In *NCS*, there is simply no reason to believe that the board behaved in any way other than perfectly selflessly. The "omnipresent specter" thus seems to have been conspicuously absent, along with any basis for applying *Unocal* scrutiny.

### B. Basis Two: Disablement under *QVC*

<sup>117</sup> NCS at 54

<sup>&</sup>lt;sup>118</sup> An odd result of *NCS* is that much greater scrutiny seems to apply to deal protections in friendly mergers, where *NCS* suggests that *Unocal* has bite, than to charter provisions designed to defend against hostile takeovers, where experience shows that *Unocal* has been defanged. *See generally* Thompson & Smith, *Sacred Space*, *supra* note 17, at 284-86 (describing weakening of the *Unocal* standard in the takeover context). This is ironic because the "omnipresent specter" of director self-interest that *Unocal* is supposed to protect shareholders against is much more apparent in the context of hostile takeovers than it is in the context of friendly mergers.

<sup>&</sup>lt;sup>119</sup> But see infra TAN XX-XX (identifying one such basis as the last period problem of target management, but arguing that such concerns can be allayed by a good faith market test without resorting to judicial review).

As an alternate basis for its holding, the majority argued that the voting agreements gave rise to a special duty on the part of the board to protect the interests of the "minority" shareholders—that is, those shareholders not party to the voting agreements. Quoting OVC for the proposition that the creation of "a cohesive group acting together" imposes special duties on the board to protect the minority shareholders, 120 the Court held that the NCS board violated those duties in failing to scrap the Genesis deal upon the subsequent appearance of Omnicare's higher bid. <sup>121</sup> Satisfying this special duty to the minority would require the retention of an effective termination right to the first transaction, which the NCS board had failed to provide by accepting the strong deal protection devices embedded in the NCS-Genesis agreement.

In NCS, the majority and minority groups were created when Outcalt and Shaw, as holders of over 50% of the NCS voting power, agreed to vote in favor of the Genesis transaction. 122 This "cohesive group" was created to accomplish the unique goal of consummating the NCS-Genesis transaction and would last only until the deal was done. During this time, however, the other NCS shareholders, now a minority, were forced to "rely for protection solely on the fiduciary duties owed to them by the directors," since they could no longer outvote Outcalt and Shaw's cohesive group. Having thus been

Paramount Communications, Inc. v. OVC Network, Inc., 637 A.2d 34, 42 (Del. 1993) (quoted in NCS at

<sup>&</sup>lt;sup>121</sup> Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*63 (Del.S.Ct. Apr. 4, 2003) (noting that the deal protections "prevented the board from discharging its fiduciary responsibilities to the minority stockholders when Omnicare presented its superior transaction").

<sup>&</sup>lt;sup>122</sup> Id.. at \*8 (noting that Outcalt and Shaw "collectively own over 65% of the voting power of NCS stock").

<sup>&</sup>lt;sup>123</sup> *Id.*, at \*64 (quoting *QVC*).

made warden of the minority shareholders' interests, <sup>124</sup> the NCS board could no longer claim that the ultimate decision on the merger was up to the shareholders. <sup>125</sup> Instead, it had taken upon itself to act for the "minority"—that is, to reject the Genesis deal the moment a superior transaction came along. <sup>126</sup>

Although the Court cites *QV* as authority for this reasoning, that case does not compel its conclusion. *QV* annot be separated from the change -of-control context on which its holding rests. The basis for the holding in that case was the *ongoing* authority, *after* the consummation of the transaction, of a single individual to control the fate of the target shareholders. No individual would have had similar authority after the consummation of the NCS-Genesis transaction. There was no change-of-control.

The absence of a change-of-control in *NCS* is a critical distinction between *NCS* and *QVC*. In *NCS*, the Outcalt and Shaw voting agreements would last only until the NCS-Genesis transaction was consummated. After that, control would revert to the aggregate voting power of the combined corporation. Going forward, there would be no individual or group exerting control over the newly formed entity. As a result, the shareholders of the new company would retain the ability "to influence corporate

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<sup>&</sup>lt;sup>124</sup> *Id.*, at \*65 ("where a cohesive group of stockholders with majority voting power was irrevocably committed to the merger transaction, effective representation of the minority shareholders imposed upon the NCS board an affirmative responsibility to protect those minority shareholders' interests") (citation and internal quotation omitted).

<sup>&</sup>lt;sup>125</sup> Under ordinary circumstances, a board has no special responsibility to rescue shareholders from a sub-optimal transaction since the shareholders themselves bear the ultimate responsibility of approving or disapproving the deal in the shareholder vote. *See* DEL.CODE ANN. TIT. 8, §251(c) (2002) (providing that an agreement of merger must be submitted to shareholders for approval).

<sup>&</sup>lt;sup>126</sup> In the words of the Court, "the NCS board was required to negotiate a fiduciary out clause to protect the NCS stockholders if the Genesis transaction became an inferior offer." *NCS*, at \*68. The Court took pains to repeat this message: "The NCS board was required to contract for an effective fiduciary out clause to exercise its continuing responsibility to the minority stockholders." *Id.*, at \*71.

 $<sup>^{127}</sup>$  See supra TAN & notes 57-62 (discussing the place of QVC in the evolving change-of-control paradigm).

direction through the ballot"<sup>128</sup> and to sell, on some future date, for a control premium. In *QVC*, by contrast, control had shifted once and for all to Sumner Redstone.<sup>129</sup> Because the Paramount-Viacom merger represented the last chance the Paramount shareholders would ever have to receive a control premium, the board was under *Revlon* duties to negotiate the best deal it could get.<sup>130</sup> The NCS Genesis transaction, in contrast, did not represent the NCS shareholders' last chance at a control premium. The cohesive group was designed only to accomplish the transaction, after which control would revert to a diffuse mass of shareholders,<sup>131</sup> which could still sell control at some point in the future.<sup>132</sup>

The invalidation of the defensive measures in *QVC* ought not to be separated from the context of a sale of control and marshaled to support a general rule about the duties of directors to "minority" interests. In *QVC*, the target board violated its fiduciary duties by not pursuing a superior offer because you can sell control once only and, for the Paramount shareholders, this was it, not because you can never commit to a binding

<sup>&</sup>lt;sup>128</sup> *Id*.

<sup>&</sup>lt;sup>129</sup> As a result of Redstone's ongoing authority over the newly formed corporation, the "stockholder votes [were] likely to become mere formalities" and the shareholders would never again have the leverage to demand a control premium. *Id.*, at 42-43.

<sup>&</sup>lt;sup>130</sup> *Id.*, at 44 ("In the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders—and they must exercise their fiduciary duties to that end.") (citing *Revlon*).

<sup>&</sup>lt;sup>131</sup> In *Arnold v. Society for Savings Bancorp*, the Court made it clear that it would grant deference to stock mergers even when a company with a very large market capitalization acquires a company with a very small market capitalization. *See* 650 A.2d 1270 (Del. 1994).

<sup>&</sup>lt;sup>132</sup> In *NCS*, the Court accepted that there had been no change-of-control. Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*39-40 (Del.S.Ct. Apr. 4, 2003) (accepting Chancery Court findings on this point).

deal. 133 Most basically, *QVC* represented the last chance that target shareholders would ever have to sell control; *NCS* did not.

The *NCS* majority opinion, however, disregarded this fundamental distinction and, having constructed a fiduciary duty to serve the "minority," held that the NCS board abdicated this responsibility by consigning the shareholders to a transaction that was already a foregone conclusion.<sup>134</sup> Because the must-submit covenant and shareholder voting agreements prevented the NCS board from carrying out this special responsibility, the Court argued that the board had "*disabled itself* from exercising its own fiduciary obligations at a time when the board's own judgment is most important, i.e., the receipt of a subsequent superior offer."<sup>135</sup> Because a board owes its fiduciary duties at all times on a continuing basis, <sup>136</sup> acts of disablement are inappropriate and void. <sup>137</sup>

This anti-disablement principle echoes *Quickturn*, <sup>138</sup> in which the Court invalidated a "no hand" poison pill on grounds that it interfered with the statutorily-protected power of a newly elected board to manage the business and affairs of the corporation. <sup>139</sup> The provision at issue in *Quickturn* would have prevented newly elected directors from removing the poison pill for six months after taking office, thus delaying

<sup>&</sup>lt;sup>133</sup> See supra TAN and note 62.

<sup>&</sup>lt;sup>134</sup> NCS, at \*65 ("The NCS board could not abdicate its fiduciary duties to the minority by leaving it to the stockholders alone to approve or disapprove the merger agreement because ... the outcome of the stockholder vote [was] a foregone conclusion.").

<sup>&</sup>lt;sup>135</sup> *Id.*, at \*68-69 (emphasis added, citations omitted).

<sup>&</sup>lt;sup>136</sup> *Id.*, at \*70.

<sup>&</sup>lt;sup>137</sup> *Id.*, at \*72.

<sup>&</sup>lt;sup>138</sup> Quickturn Design Systems, Inc. v. Shapiro, 721 A.2d 1281 (1998) (hereinafter *Quickturn*).

<sup>&</sup>lt;sup>139</sup> *Id.*, at 1292. The power of a board to manage the corporation is protected by DGCL 141(a). DEL.CODE ANN. TIT. 8, §141(a) (2002).

the ability of a would-be acquiror to consummate a tender offer. Because the inability of a new board to accept a tender offer essentially amounts to an arbitrary rejection of any such offer and because a board may not, consistent with its fiduciary duties, behave arbitrarily when faced with a takeover bid, any provision so disabling a board must be invalid. Although the *NCS* Court does not cite *Quickturn* as authority for its anti-disablement language, the principle that a board may not contract to disable itself from carrying out its fiduciary duties is most fully articulated in that case.

However, even the reasoning of *Quickturn* does not compel the conclusion that the NCS board disabled itself in a manner inconsistent with its fiduciary duties.

Although at first glance, a precommitment strategy in favor of a particular transaction may appear similar to a provision committing a successor board to reject takeover proposals—after all, a protected deal will result in the board's rejection of interim transaction proposals—there is a significant difference. Most basically, saying no is not the same as saying yes. A commitment to reject *all* offers is a simple *negative* action and is unlikely to promote shareholder welfare because an offer may well arise that would be in shareholders' best interest to take. Once a target has said yes, however, the commitment to reject *intervening* offers is not the same. Because the target has already accepted a particular transaction as maximizing shareholder welfare, the rejection of intervening offers is merely the *continuation* of the *affirmative* act—that is, the

<sup>&</sup>lt;sup>140</sup> *Quickturn*, at 1287. Poison pills, or Rights Plans, are anti-takeover provisions that make tender offers prohibitively expensive for would-be acquirors. The adoption and use of such provisions have been deemed acceptable under Delaware law. *See* Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985) (hereinafter *Moran*). However, innovations on the standard pill that prevent newly elected directors from removing the pill have been held invalid. *See*, *e.g.*, Carmody v. Toll Brothers, Inc., 723 A.2d 1180 (Del. Ch., Jacobs, V.C., 1998); *Quickturn*, 721 A.2d 1281.

<sup>&</sup>lt;sup>141</sup> See Moran, 500 A.2d 1346, 1353 (cited in Quickturn).

<sup>&</sup>lt;sup>142</sup> *Ouickturn*, at 1291-92.

acceptance of the favored transaction. Preventing the board from rejecting intervening bids means preventing the board from acting affirmatively in the first place. If a target cannot *commit* to saying yes, it cannot say yes at all. All it can ever say is maybe—that is, "maybe we will consummate this transaction, provided that something better does not come along."

Quickturn stands for the proposition that a board cannot adopt a negative precommitment strategy. 143 A board cannot bind itself simply to say no. But it is silent on whether a board may adopt an affirmative precommitment strategy. And, as noted above, the same rationale does not underlie both negative and affirmative precommitment strategies. 144 Denying a board the ability to precommit in this context moves Delaware to the rule of the Nebraska Supreme Court in *ConAgra*, which effectively makes all merger contracts into merger options until the closing of the deal. No Delaware court has yet taken this extreme position, and were one to do so, it ought to do so explicitly so that all participants in the system of Delaware law would understand that the world has changed. Because the courts in neither Quickturn nor NCS explicitly adopted such a rule, their opinions ought not to be read as though they had.

The NCS board sought to follow an affirmative precommitment strategy. Therefore, the anti-disablement principle derived from *Quickturn* does not mandate the

<sup>&</sup>lt;sup>143</sup> The *Quickturn* rule can be distilled as follows: if a board chooses to say no and remain independent. then it has a duty to its shareholders to consider each new offer as it arises and to justify its defensive package as applied to every offer. A board cannot simply say no and disengage from the process because at some point saying yes might be in the best interests of its shareholders.

<sup>&</sup>lt;sup>144</sup> A board follows an *affirmative* precommitment strategy when it says no to intervening bidders only to execute its answer of yes to a prior bidder.

<sup>&</sup>lt;sup>145</sup> ConAgra, Inc. v. Cargill, Inc., 222 Neb. 136, 156 (1986) (holding that a target board was obligated to recommend a subsequent superior offer to its shareholders notwithstanding the existence of a definitive merger agreement with another bidder). See also Paul K. Rowe, The Future of the "Friendly Deal" in

invalidation of the deal protections in *NCS*. Moreover, the fiduciary duty principles that operated to invalidate the deal protections in *QVC*annot be separated from the context of a change-of-control, which is not the case in *NCS*. As a result, the doctrinal authority cited in *NCS* as the second basis for the holding, like the *Unocal* analysis underlying the first basis, does not compel the majority's inflexible rule against precommitment.

#### IV. The Benefits of Precommitment

So why did the Court go out of its way to establish a rule requiring boards to embed fiduciary outs in friendly mergers in the absence of doctrinal authority compelling it to do so? Making fiduciary outs a requirement of law is not, after all, a moderate holding consistent with the cautious, fact-intensive nature of the Delaware corporate law. The holding seems more like an attempt of the Court to micro-manage the deal process, similar to the apparent requirement, after *Van Gorkom*, that boards receive an investment banker's fairness opinion before agreeing to a deal. But rather than a carefully reasoned legal mandate, the opinion is perhaps best understood as an expression

*Delaware*, 1 (July 10, 2000) (unpublished manuscript, on file with author) (criticizing *ConAgra* and insisting that "Delaware is not an 'option' state; there *is* such a thing as a real merger agreement")

<sup>&</sup>lt;sup>146</sup> Writing in dissent, Chief Justice Veasey praised flexibility and fact intensive adjudication as "[t]he beauty of the Delaware corporation law," in contrast to the majority's bright line rule. Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*73 (Del.S.Ct. Apr. 4, 2003) (Veasey, dissenting). *See also* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1015 (1997) ("the Delaware courts fill out the concept of "good faith" through fact-intensive, normatively saturated descriptions of manager, director, and lawyer conduct, and of process - descriptions that are not reducible to [bright-line] rules").

<sup>&</sup>lt;sup>147</sup> Van Gorkom, 488 A.2d 858, 874 (Del. 1985). See also Helen M. Bowers, Fairness Opinions and the Business Judgment Rule: An Empirical Investigation of Target Firms' Use of Fairness Opinions, 96 Nw. U. L. Rev. 567, 577 (2002) (finding a temporary surge in target firms' use of fairness opinions after Van Gorkom); Dierdre A. Burgman & Paul N. Cox, Corporate Directors, Corporate Realitites and Deliberative Process: An Analysis of the Trans Union Case, 11 J. CORP. L. 311, 333 n.146 (noting practitioner reaction to Van Gorkom as "the investment bankers' full employment act").

of the Court's—or, at least, three Justices'—open hostility to completely protected merger agreements. The question remains, however, whether such hostility is warranted.

Entering a transaction with fiduciary outs is like making a promise with your fingers crossed. It prevents either party to the bargain from being certain that the transaction will actually occur. By requiring boards to include effective fiduciary outs in merger transactions, the Court has foreclosed certain strategic alternatives otherwise available to target boards. A board that cannot pursue a precommitment strategy can no longer control the merger process. Without the ability credibly to commit to a particular offer and thereby end merger negotiations, no bid can ever be accepted. Instead, every acceptance comes with strings—a fiduciary out clause—and intervening bidders can always trump the offer on the table. Simply stated, in a world where fiduciary outs are a legal requirement, transactional commitments are no longer credible and thus hardly amount to commitments at all.

Whether individuals or organizations ought to be able to pursue particular commitment strategies is a question with several interesting theoretical aspects, addressed in the sections that follow. Regardless of how the question is asked, however, it is plain that the majority's analysis did not adequately address the considerations arising from the elimination of precommitment. A close evaluation of these considerations shows that a *per se* rule foreclosing precommitment strategies is likely to be undesirable from the perspective of the target corporation and its shareholders.

#### A. Commitment Theory

When an individual commits to a course of action, she binds herself tomorrow to a path she chooses today. 148 She uses her current preferences to restrict her future set of choices. This may seem odd from the perspective of rational choice theory since individual welfare would appear to be diminished rather than enhanced by reducing the spectrum of available choices. 149 Yet this is precisely how individuals do in fact behave. 150 Childrendrop coins into porcelain piggy banks. Governments create social security programs, and firms establish mandatory pension plans. Dieters throw out chocolate and ice cream. Adults ask, at the beginning of an evening, not to be served a second drink when they later request one, or alternately, they surrender their keys upon entering the party.

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[T]ake me and bind me to the crosspiece half way up the mast; bind me as I stand upright, with a bond so fast that I cannot possibly break away, and lash the rope's ends to the mast itself. If I beg and pray you to set me free, then bind me more tightly still.

Odyssey, XII, (G. Butler, trans.). Citations to this episode appear in Dresser, *infra* note 157, ELSTER, *infra* note 151, Strotz, *infra* note 158, among others.

<sup>&</sup>lt;sup>148</sup> Much of the literature on constraints and commitments cites the story of Ulysses and the Sirens. Prior to stopping his oarsmen's ears with wax, Ulysses instructed them:

<sup>&</sup>lt;sup>149</sup> See Bruce Chapman, Rational Commitment and Legal Reason (May 2003) U Toronto Law and Economics Research Paper No. 03-02; U of Toronto, Public Law Research Paper No. 03-02, unpublished manuscript available online at <a href="http://ssrn.com/abstract=417081">http://ssrn.com/abstract=417081</a> (describing the challenge that rational commitment presents to economic theory as a clash between the decision of the agent *ex ante* to make commitments in spite of her incentives *ex post* not to carry them out resulting in the foresightful agent's inability *ex ante* to enter into credible commitments); *see also* JEAN-JACQUES ROUSSEAU, THE SOCIAL CONTRACT (1792) (stating that "it is absurd for the will to put itself in chains for the future"), *quoted in* E. ALLAN FARNSWORTH, CHANGING YOUR MIND 1 (1998). On the definition of rational choice theory, see Thomas S. Ulen, *Rational Choice Theory in Law and Economics, in* ENCYCLOPEDIA OF LAW AND ECONOMICS (Boudwijn Bockaert & Gerrit De Geest eds., 1999) (defining rational choice theory around core insight that "[QUOTATION PENDING]").

<sup>&</sup>lt;sup>150</sup> See generally Thomas C. Schelling, Choice and Consequence 57-112 (1984) (providing numerous examples).

Commitments such as these can be viewed as devices to protect against flagging self-control. <sup>151</sup> In making them, the individual acknowledges that in the future, her preferences will change and she will lack the will to carry out her current plans. This disconnect between present and future preferences highlights concerns regarding the bounded rationality of decision-making <sup>152</sup> and the conceptual unity of individual selves. <sup>153</sup> Uncontrollable behavior, especially actions influenced by addiction or cravings, <sup>154</sup> departs from the model of rational welfare maximization and supports accounts of human rationality as bounded. <sup>155</sup> And conflicts between an individual's

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<sup>&</sup>lt;sup>151</sup> Jon Elster has discussed the possibility of a "theory of constraints" from various solution strategies to the problem of self-control. Jon Elster, Ulysses Unbound: Studies in Rationality, Precommitment, and Constraints, 270-82 (2000) (presenting an admittedly unsystematic account and leaving open the tantalizing question of optimal constraints). *See also* Thomas C. Schelling, *Enforcing Rules on Oneself*, 1J. L. E con. & Org. 357 (1985) (proposing a hierarchy of rules that individuals use to influence their future conduct and a structure for evaluating the likely success of those rules).

<sup>&</sup>lt;sup>152</sup> See Russell B. Korobkin & Thomas S. Ulen, Law and Behavioral Science: Removing the Rationality Assumptions from Law and Economics, 88 Cal. L. Rev. 1051 (2000) (critiquing rational choice theory with evidence from behavioral science); Amartya K. Sen, Rational Fools: A Critique of the Behavioral Foundations of Economic Theory, 6 Philosophy and Public Affairs 317, 322-325 (1977) (criticizing rational choice theory on the basis of inconsistencies in revealed preferences).

<sup>153</sup> See SCHELLING, supra note 150, at 86-87 (1984) (treating the problem of commitment and self-control as involving "a succession or alternation of impermanent selves, each in command part of the time, each with its own needs and desires during the time it is in command but having—at least some of them—strong preferences about what is done during the period that another one is in command"); Richard A. Posner, Are We One Self or Multiple Selves? Implications for Law and Public Policy, 3 Legal Theory 23, 25 (1997) (arguing that weakness of will and shortsightedness do not signify irrationality but rather "are products of the fact that human behavior is the result of conflict between ... two selves that each person has—the future-oriented self ... and the present-oriented self ...—both of which are fully rational in the economic sense"). For other analyses employing a conceptual model of multiple selves, see e.g., ADAM SMITH, THE THEORY OF MORAL SENTIMENTS, Bk. III, Ch. 4 (1759) (employing a two-self model to analyze individual choice); Richard H. Thaler and H.M. Shefrin, An Economic Theory of Self-Control, 89 J. POL. ECON. 392 (1981) (constructing a two-self model of economic man, according to which consumption choices emerge from the interplay of a "planner" self and a "doer" self).

<sup>&</sup>lt;sup>154</sup> See generally George Loewenstein, Out of Control: Visceral Influences on Behavior, 65 ORG. BEHAV. & HUM. DECISION PROCESSES 272 (1996) (noting that although individuals may plan to resist an action for its undesirable consequences, visceral factors may arise to increase the momentary valuation of an activity, causing the individual to deviate from their prior plans).

<sup>&</sup>lt;sup>155</sup> See generally, James G. March, Bounded Rationality, Ambiguity, and the Engineering of Choice, 9 Bell J. Econ. 587, 590 (1978) (discussing concept of limited or bounded rationality).

present and future interests gives rise to the question of which set of interests—past, present, or future—constitutes the authentic self.<sup>156</sup>

At the level of legal policy analysis, the question becomes which self's interests should control in cases of conflict, as when a later self seeks to enlist the legal system to free it from a commitment made by a prior self. However, once the problem is framed to involve the interests of competing equally authentic selves, a host of difficult issues arises. Once differences in preferences over time are treated as alternate competing selves, inter*temporal* utility comparisons become the functional equivalent of inter*personal* utility comparisons, <sup>158</sup> raising the same arguably irresolvable problems. <sup>159</sup>

When we identify a consumer attempting to exercise command over his own future behavior, to frustrate some of his own preferences, we import into the individual a counterpart—I think an almost exact counterpart—to interpersonal utility comparisons. Each self is a set of values; and though the selves share most of those values, on particular issues on which they differ fundamentally there doesn't seem to be any way to compare their utility increments and to determine which behavior maximizes their collective utility.

Thomas C. Schelling, *Self-Command in Practice, in Policy and in a Theory of Rational Choice,* 74 AM. ECON. REV. PAPERS & PROC., May 1984, at 7-8. *See also* R. H. Strotz, *Myopia and Inconsistency in Dynamic Utility Maximization,* 23 REV. ECON. STUD. 165, 179 (1955) ("The individual over time is an infinity of individuals, and the familiar problems of interpersonal utility comparisons are there to plague us.").

<sup>&</sup>lt;sup>156</sup> See George Loewenstein & Richard H. Thaler, *Anomalies: Intertemporal Choice*, 3 J. ECON. PERSP. 181, 186 (1989) ("Who is sovereign, the self who sets the alarm clock to rise early, or the self who shuts it off the next morning and goes back to sleep?").

<sup>&</sup>lt;sup>157</sup> Examples raise issues that are morally and ethically laden. *See, e.g.,* Rebecca S. Dresser, *Ulysses and the Psychiatrists: A Legal and Policy Analysis of the Voluntary Commitment Contract,* 16 HARV. C.R.-C.L. L. REV. 777 (1982) (analyzing the issues raised when a psychiatric patient who has voluntarily confined herself subsequently changes her mind and refuses further treatment); John A. Robertson, *Precommitment Strategies for the Disposition of Frozen Embryos,* 50 Emory L. J. 989 (2001) (discussing whether to honor agreements regarding the treatment of frozen embryos in the event of subsequent divorce).

<sup>&</sup>lt;sup>158</sup> Schelling acknowledges this problem most explicitly:

<sup>159</sup> Interpersonal utility comparisons raise problems of value judgments in the definition and measurement of "utility" and problems relating to the comparison of subjective states of well-being. *See generally* JON ELSTER & JOHN E. ROEMER, EDS, INTERPERSONAL COMPARISONS OF WELL-BEING (1991) (presenting the problem and various proposals for solutions). Economists generally concede that these problems cannot be solved. *See* Gary Lawson, *Efficiency And Individualism*, 42 DUKE L.J. 53, 61 (1992) ("The near-uniform answer of modern economists and legal scholars is ... that it is impossible to make interpersonal comparisons of utility.") (emphasis and citations omitted). As a result, economists seek to define their terms in a way that avoids the problem of interpersonal utility comparisons. *See* RICHARD A. POSNER, THE

Similarly, if the individual is viewed as a collection of competing interests without a clear center of authority, collective action problems may be seen to arise among the multiple selves to prevent the individual from ordering her actions to achieve the best outcome for herself (or selves) as a whole. Contractarian solutions to these dilemmas are not obviously available since the later self—the one actually bound—was not at the metaphorical bargaining table and therefore could not consent when the former self agreed to bind it. Moreover, with no obvious basis for favoring the interests of a present self over a future self, or *vice versa*, or for comparing and combining the welfare

ECONOMICS OF JUSTICE 48-87 (1981) (summarizing critiques of utilitarianism arising from the measurement and comparison of utility and replacing utility maximization with wealth maximization in order to shield economic analysis from similar criticisms). *But see* Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 985 n.42 (2001) (acknowledging that welfare economics provides no "uncontroversial, verifiable way" of making interpersonal utility comparisons, but insisting that "there do exist coherent approaches to the task"). Kaplow and Shavell cite Harsanyi as offering a promising approach. John C. Harsanyi, *Cardinal Welfare, Individualistic Ethics, and Interpersonal Comparisons of Utility*, 63 J. POL. ECON. 309 (1955) (suggesting that utilities could be compared by constructing a matrix that showed the effects of competing policies, weighted by the number of persons effected).

Contracts are made between two parties. The court adjudicates conflict when one party complains of the other's nonperformance. ... [D]espite the appeal of the 'two-persons' metaphor in matters of preference conflict and self-discipline, it fails in its application to contracts for the very simple reason that there the two people involved never exist simultaneously. ... In place of contract, we have the imposition of a rule or constraint on the future self by the present self—the future self never signs on with those rules. Rather than contract law, the appropriate analogy would seem to be criminal law where someone imposes rules of behavior on an individual, whether he likes it or not.

Id., at 378. By "contractarian," I mean the view that outcomes resulting from an agreement between informed and impartial persons bargaining in good faith are presumptively fair. *See generally* JOHN RAWLS, A THEORY OF JUSTICE (1971) (elaborating a contractarian theory of the distribution of social goods).

<sup>&</sup>lt;sup>160</sup> See Korobkin & Ulen, supra note 152, at 1123 (noting that "each individual may be viewed as a collection of competing preference orderings [and as a result] there may be a collective action problem in aggregating the contemporaneous preferences of these multiple selves").

<sup>&</sup>lt;sup>161</sup> See Gordon C. Winston, *The Reasons of Being of Two Minds: A Comment on Schelling's 'Enforcing Rules on Oneself,'* 1J. L. E CON. & ORG. 375 (1985) (rejecting the contract metaphor):

functions of the competing selves, how can one determine whether the later self would have agreed to be bound in a hypothetical bargain?<sup>162</sup>

The law does not take the problem of multiple selves seriously in the abstract, <sup>163</sup> but rather analyzes commitment issues in light of competing policy concerns. <sup>164</sup> Most instances of *self*-binding, because they do not involve contractual counterparties, are not legally enforceable. <sup>165</sup> When an individual seeks to commit herself by contracting with another person, however, the law is apt to enforce the promise. <sup>166</sup> Although exceptions exist for sufficiently serious policy concerns—enlisting others for purposes of self-incarceration, for example, raises basic concerns regarding an individual's inalienable

When we ask the mother who an hour ago was frantic with pain whether she is glad the anesthesia was denied her, I expect her to answer yes. But I don't see what that proves. If we ask her while she is in pain, we'll get another answer.

Schelling, *supra* note 158, at 8. *See also* Robert A. Burt, *Commentary on Schelling's 'Enforcing Rules on Oneself,"* 1 J. L. ECON. & ORG. 381, 381 (1985) (arguing that "no generalization can be made about the inherent superiority of conflicting initial or subsequent preferences as such" and criticizing Schelling for "priz[ing] initial over subsequent preferences" and "valu[ing] initial deliberative processes over subsequent possible occasions for reconsideration"); SCHELLING, *supra* note 150, at 108 (noting that "if both selves deserve recognition, the issue is *distributive*, not one of *identification*. We can do cost-benefit analysis and try to maximize their joint utility. But it is *we* and not *they* who are concerned with joint utility.") (emphasis in original).

For society and the law, the question of whether to enforce [precommitments] -- whether to prefer freedom at Time A or freedom at Time B -- is more policy-oriented and pragmatic. That judgment depends on many factors, including the knowledge and circumstances in which the precommitment was made, the freedom or activity that is precommitted, the gains from precommitment, the costs of regret at Time B, and the reliance interests of other persons in enforcing the commitment. ... Rather than prescribe precommitment policy generally, each precommitment situation must be assessed on its own terms, with a recognition and assessment of the temporal choice trade-offs that are at stake in that instance.

Robertson, *supra* note 157, at 1044-45 (citation omitted).

<sup>&</sup>lt;sup>162</sup> Schelling illustrates this problem with the example of a woman who has requested that she be denied anesthesia during labor, asking when it is appropriate to analyze whether she has maximized her welfare:

<sup>&</sup>lt;sup>163</sup> See Schelling, supra note 150, at 96 ("The law does not like to distinguish these different selves, or to differentiate an authentic self from imposters.").

<sup>&</sup>lt;sup>164</sup> According to Professor Robertson:

<sup>&</sup>lt;sup>165</sup> See Schelling, supra note 151, at 359 ("We must devise rules for our own behavior that entail little or no reliance on the courts... because the courts refuse to extend to us our jurisdiction.").

<sup>&</sup>lt;sup>166</sup> See CHARLES FRIED, CONTRACT AS PROMISE 41-43 (1981) (distinguishing promises and vows).

right to liberty, resulting in a denial of specific enforcement in contract<sup>167</sup> and raising constitutional doubts if a state actor becomes involved<sup>168</sup>—the general interest of the law in promoting reciprocal exchange<sup>169</sup> and protecting the expectation or reliance interests of the other party favors upholding the bargain.<sup>170</sup>

The parallel in corporations to the individual's multiple selves problem lies in the nature of the business entity as a collection of interests that are sometimes cohesive, sometimes competing.<sup>171</sup> This perspective is most vividly captured by theories of the firm that portray the corporation as nothing more than a collection of implicit and explicit contracts between various participants in the business enterprise. <sup>172</sup> Envisioning the firm

[w]e disregard the [multiple selves] argument and insist on a concept of personhood that embraces the succession of selves because to do so promotes social welfare overall by maintaining what are considered socially valuable institutions, such as contract and criminal punishment.

Posner, *supra* note 153, at 34. *Accord* E. ALLAN FARNSWORTH, CONTRACTS §1.7 (3d ed. 1999) ("From a utilitarian point of view, freedom to contract maximizes the welfare of the parties and therefore the good of society as a whole.").

"Connected contracts" may be thought of as shorthand for a fluid, nonlinear, nonhierarchical set of interactions and interrelationships. It challenges the notion of ownership and the corporate law model of shareholder primacy. It is virtually the antithesis of theories of the firm that seek to identify the boundaries of that fiction or artificial construct.

Gulati, Klein, and Zolt, *supra* note XX, at 894-95. Other theorists model the firm as a "nexus" of contracts, with various competing implications. *See* EASTERBROOK & FISCHEL, *supra* note XX, at 12 ("we often speak of the corporation as a 'nexus of contracts' or a set of implicit and explicit contracts… [which is]

<sup>&</sup>lt;sup>167</sup> In Corbin's words, "We insist on liberty even at the expense of broken promises. Imprisonment for debt has been abolished; and imprisonment as punishment for contempt of a court's order to perform other kinds of promises is regarded with similar disfavor." 5A A. CORBIN, CONTRACTS §1204 (rev. ed. 1964) (cited in Dresser, *supra* note 157, at 793).

<sup>&</sup>lt;sup>168</sup> See Dresser, supra note 157, at 794-826 (discussing constitutional issues raised by voluntary commitment).

<sup>&</sup>lt;sup>169</sup> In such contexts:

<sup>&</sup>lt;sup>170</sup> See FRIED, supra note 166, at 17 ("[Contract] provides a way that a person may create expectations in others. By virtue of the basic Kantian principles of trust and respect, it is wrong to invoke that convention in order to make a promise, and then to break it.").

<sup>&</sup>lt;sup>171</sup> See generally Symposium: Team Production in Business Organizations, 24 J. CORP. LAW \_\_ (1999). (emphasizing the contributions of various inputs in the nexus of corporate contracts).

<sup>&</sup>lt;sup>172</sup> The most radical example may be Gulati, Klein, and Zolt's model of "connected contracts":

as a complex set of bargains rather than a simple entity with owners and managers gives rise to concerns similar to the multiple selves problem. Which stakeholders ought to be favored in situations of conflict? Which constituencies are directors supposed to represent? Provided they do not simply represent themselves, the shelter of the business judgment rule protects directors when they make decisions for the business as a whole. The law allows them, in other words, to enter into contracts to bind the corporation as an entity, notwithstanding the clash among its various constituencies. The law's disregard of abstract theoretical concerns beneath the fiction of corporate personhood parallels its disregard for the conflict between an individual's multiple selves. Absent competing policy concerns, which in the corporate context typically involve some breach of fiduciary duty, courts will respect the contractual commitments made by a director on behalf of the corporation.

An emerging literature investigates contractual precommitment in corporate law, discussing commitment strategies in a number of corporate and securities law contexts,

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shorthand for the set of complex arrangements of many sorts that those who associate voluntarily in the corporation will work out among themselves"); Bainbridge, Board as Nexus, supra note XX, at 7 ("At the core of the director primacy model therefore lies the normative claim that the virtues of fiat, in terms of corporate decisionmaking efficiency, can be ensured only by preserving the board's decisionmaking authority from being trumped by either shareholders or courts."); Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporate Law, 85 VA. L. REV. 247, 254 (1999) (articulating a team production model of the corporation that "is consistent with the 'nexus of contracts' approach to understanding corporate law"). The models of lawyer-economists are often informed by the models of financial economists. See, e.g., Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 AM. ECON. REV. 777 (1972) (describing problems of "team production" as those in which a productive activity requires the combined investment and coordinated effort of two or more individuals or groups); Ronald H. Coase, The Nature of the Firm, 4 ECONOMICA 386 (1937) (describing boundaries of the firm as a function of transaction costs); Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 310 (1976) (arguing that corporations are "simply legal fictions which serve as a nexus for a set of contracting relationships among individuals.").

<sup>&</sup>lt;sup>173</sup> D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 279-80 (1998) (noting that "[o]utside the takeover context, application of the shareholder primacy norm to publicly traded corporations is muted by the business judgment rule").

including anti-takeover provisions,  $^{174}$  mandatory disclosure regulation,  $^{175}$  and board governance generally.  $^{176}$  Deal protections present a paradigmatic example of a corporate precommitment. Upon signing a merger agreement with an acquiror (A), the target's earlier self (T<sub>0</sub>) requires its later selves (T<sub>n</sub>) not to solicit competing bids, not to entertain competing offers, and to compensate the acquiror if the merger is not consummated.  $^{177}$  Of course, from the *ex post* point of view of T<sub>n</sub>, this agreement may not seem optimal, especially if an intervening bidder (B) has arisen and the deal protection provisions embedded in the original merger agreement with A preclude T<sub>n</sub> from seeking a deal with B.  $^{178}$  From the *ex ante* point of view of T<sub>0</sub>, however, there may have been compelling reasons for agreeing to the deal protection provisions.  $^{179}$  Moreover, once the

<sup>174</sup> Stephen M. Bainbridge, *Dead Hand and No Hand Pills: Precommitment Strategies in Corporate Law*, \_\_\_\_\_PENN. L. REV. \_\_\_\_ (forthcoming), at [7] (discussing shareholder rights plans in the context of precommitment and noting that "[0]ther-regarding precommitments address strategic behavior by making both threats and promises more credible"); Marcel Kahan and Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Pre-Commitment*, \_\_\_\_ PENN. L. REV. \_\_\_\_ (forthcoming) (arguing that *ex ante* shareholders may rationally precommit to board entrenchment devices such as poison pills and staggered boards in order to improve their payout in a negotiated acquisition *ex post*);

<sup>&</sup>lt;sup>175</sup> See Edward Rock, Securities Regulation As Lobster Trap: A Credible Commitment Theory Of Mandatory Disclosure, 23 CARDOZO L. REV. 675, 676 (2002) (arguing that "an important but largely unappreciated function of the U.S. mandatory disclosure regime is the extent to which it permits issuers to make a credible commitment to a level and permanence of disclosure.").

<sup>&</sup>lt;sup>176</sup> See Lynn Stout, The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance, 152 U. PA. L. REV. \_\_\_\_ (forthcoming 2003) (arguing that shareholders cede to board governance as a means of self-binding in order to induce other constituencies, such as creditors and employees, to invest optimally in the firm).

<sup>&</sup>lt;sup>177</sup> These are standard no-shop, no-talk, and termination fee provisions common in merger agreements. See generally *Panel on Negotiating Acquisitions of Public Companies*, 10 U. MIAMI BUS. L. REV. 219 Appendices F (no-shops and no-talks) and J (termination fees) (2002).

<sup>&</sup>lt;sup>178</sup> The Court engaged in precisely this form of analysis when it compared the consideration agreed upon in the Genesis transaction with the final Omnicare proposal and, because Omnicare's offer was significantly better, concluded that it was plainly in the best interests of shareholders to get out of the Genesis transaction and do a deal with Omnicare. Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*68-69 (Del.S.Ct. Apr. 4, 2003).

<sup>&</sup>lt;sup>179</sup> An obvious compelling reason is A's insistence that the deal be final so that it is not later subject to *ex post* rent extraction. *See generally* Peter Cramton and Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7J. OF L. ECON. & ORG. 27, 41 (1991) (hereinafter Cramton & Schwartz, *Auction* 

commitment is given, the reliance and expectation interests of A are implicated. In the absence of a strong policy consideration to the contrary and following the general policy of promoting reciprocal exchange and protecting expectation and reliance interests, we ought to expect courts to enforce this contract.

Professor Regan has articulated a framework for analyzing deal protections in light of the expectation and reliance interests of the would-be acquiror. Focusing on the change-of-control context, Professor Regan builds upon principles of trust, agency, and contract law, to support invalidation of deal protection provisions when the target board breaches its fiduciary duties by agreeing to them. This is similar to the general approach, described above, according to which the law honors contractual commitments unless there is a countervailing policy concern. In Professor Regan's model, the competing policy concern is the breach of fiduciary duty, and the fact that the would-be acquiror knew or should have known that the target was breaching its fiduciary duty in agreeing to the deal protections is cited as justification for invalidating that party's expectation or reliance interest.

*Theory*) (discussing auction theory in the context of takeovers and noting that "[p]ostauction negotiations create the possibility of ex post opportunism and consequent ex ante welfare losses...").

recommend[ing] that a court [evaluating deal protections in a change-of-control transaction] consider the following criteria: (1) whether the acquiror knew, or should have known, of the target board's breach of fiduciary duty; (2) whether the change of control transaction remains pending or is already consummated at the time that judicial intervention is sought; (3) whether the board's violation of fiduciary duty relates to policy concerns that are especially significant; and (4) whether the acquiror's reliance interest under the challenged agreement merits protection in the event the court were to declare the agreement unenforcable.

<sup>&</sup>lt;sup>180</sup> Paul L. Regan, *Great Expectations? A Contract Law Analysis For Preclusive Corporate Lock-Ups*, 21 CARDOZO L. REV. 1 (1999).

<sup>&</sup>lt;sup>181</sup> *Id.*, at 100-113.

<sup>&</sup>lt;sup>182</sup> See supra TAN and notes 166-170.

<sup>&</sup>lt;sup>183</sup> See id., at 118:

The target board's breach of fiduciary duty is the key to this analysis. Without an underlying breach of fiduciary duty, there is no policy justification for invalidating the would-be acquirer's contractual interests in the enforcement of the deal protection provisions. On this point, it is worth emphasizing that Professor Regan confined his analysis to deal protections in the change-of-control context. In the context of a changeof-control transaction, a board's use of contractual provisions used to protect a favored transaction against competing alternatives can easily amount to a breach of fiduciary duty. Since Revlon targets and acquirors have known that a board violates its fiduciary duties by failing to maximize the consideration paid to shareholders in a change-ofcontrol transaction. 184 If the inclusion of deal protection provisions fails to maximize shareholder consideration, the target board breaches its fiduciary duty in agreeing to them and, because all parties ought to have understood this, does not trigger any valid expectation or reliance interest on the part of the would-be acquiror. 185 The commitment embodied in the merger agreement's deal protection provisions ought therefore to be invalidated.

In the non-change-of-control context, however, Professor Regan's analysis is not apt since the board's special duties in connection with a change-of-control supplies the

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<sup>&</sup>lt;sup>184</sup> Revlon v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1985). *See also supra* Part II.B.1. (discussing the change-of-control paradigm). In the context of a change-of-control transaction, there is no place for deal protections that are not designed expressly to maximize the consideration paid in the deal. However, deal protections may be deemed valid if used to protect a process designed to maximize shareholder consideration, as when they are used to protect the transaction that has emerged as the winner of an auction process. *See supra* note 96 (citing and discussing *Renaissance* and *Rand* in support of this proposition).

<sup>&</sup>lt;sup>185</sup> See Regan, supra note 180, at 100 ("As for the acquiring corporation's contractual expectation interest [in deal protection provisions embedded in a transaction involving a change-of-control], a signed deal here translates into 'all bets are off."").

breach of fiduciary duty that drives the rest of the analysis.<sup>186</sup> In a non-change-of-control context, it is not necessarily a breach of fiduciary duty to fail to maximize shareholder consideration.<sup>187</sup> As a result, in order for fiduciary duty concerns to override the protection of contractual expectations in a non-change-of-control transaction, another breach must be found. Because all of the recent deal protection cases—*Phelps*,<sup>188</sup> *ACE*,<sup>189</sup> *IXC*,<sup>190</sup> *Bartlett*,<sup>191</sup> and *NCS*<sup>192</sup>—involve friendly non-change-of-control transactions, Professor Regan's analytic framework would not be especially relevant, had Vice Chancellor Strine not sought to apply it.

In *ACE*, Vice Chancellor Strine sought to apply Professor Regan's framework to a provision of the merger agreement between ACE and Capital Re that precluded Capital Re (the target) from negotiating with intervening bidders unless its outside counsel furnished a written opinion stating that such negotiations were required to prevent the board from breaching its fiduciary duties. Although the ACE Capital Re transaction

In the extraordinary context of a "bet the company" board decision to sell control... the concern for [the fiduciary relationship between shareholders and directors] finds perhaps its greatest intensity. ... In contract law terms, a board's violation of fiduciary duty in this context presents a compelling case for displacing the usual priority of protecting contractual expectations.

<sup>&</sup>lt;sup>186</sup> See id., at 107:

<sup>&</sup>lt;sup>187</sup> See supra Part II.B.1.

<sup>&</sup>lt;sup>188</sup> Phelps Dodge Corp. v. Cyprus Amax Minerals Co., 1999 Del. Ch. LEXIS 202 (Del. Ch., Sept. 27, 1999).

<sup>&</sup>lt;sup>189</sup> ACE Ltd. v. Capital Re Corp., 747 A.2d 95 (Del. Ch., Oct. 28, 1999).

<sup>&</sup>lt;sup>190</sup> In re IXC Communications, Inc. Shareholders Litigation, 1999 Del. Ch. LEXIS 210 (Del. Ch., Oct. 27, 1999).

<sup>&</sup>lt;sup>191</sup> State of Wisconsin Investment Board v. Bartlett, C.A. No. 17727, 2000 Del. Ch. LEXIS 42 (Del. Ch. Feb. 24, 2000).

<sup>&</sup>lt;sup>192</sup> Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195 (Del.S.Ct. Apr. 4, 2003).

<sup>&</sup>lt;sup>193</sup> See ACE at 104-110. Vice Chancellor Strine paraphrased Professor Regan's findings, reciting them as authority:

did not itself involve a change-of-control, thus triggering special fiduciary duty concerns, this odd provision may well have amounted to a *per se* fiduciary duty violation since it purported to delegate a significant aspect of the target board's decision-making authority to a non-director. Vice Chancellor Strine seized on this aspect of the provision, describing it as "pernicious" and connecting it to a line of Delaware cases finding that abdication or disablement of board decision-making constitutes a breach of fiduciary duty. Because the provision itself likely constituted a breach of fiduciary duty on these separate, rather idiosyncratic grounds, Vice Chancellor Strine could follow Professor Regan's analysis and invalidate the contractual provision as a breach of fiduciary duty without ever confronting the question of whether the target board was under a fiduciary duty to consider subsequent bids. 195

This gives rise to an interesting thought problem: Would *ACE* have been decided differently if, rather than delegating the determination of whether to consider future bids to its outside counsel, the Capital Re board had simply promised to submit the ACE transaction to a shareholder vote without negotiating with any other bidders in the interim? Such a provision would not have violated the anti-disablement principle, <sup>196</sup> yet

Generally, where the other party had reason to know that the trustee or agent was on thin ice, where the trustee's or agent's breach has seriously negative consequences for her ward, and where the contract is as yet still unperformed, the law will not enforce the contract but may award reliance damages to the other party if that party is sufficiently non-culpable for the trustee's or agent's breach

Id., at 104.

<sup>&</sup>lt;sup>194</sup> *Id.*, at 106-107 (citing *QV@*nd *Quickturn*, among others). For further discussion of the anti-disablement principle in Delaware, see *supra* Part III.B.

<sup>&</sup>lt;sup>195</sup> *Id.*, at 109-110.

<sup>&</sup>lt;sup>196</sup> The principle animating Strine's decision appears to be the delegation of a core director responsibility to outside counsel, disabling the board from carrying out its fiduciary duties at a critical moment—that is, a decision of how to sell the company. Delegations of corporate responsibility, however, are generally permissible when the result of a good faith business judgment. According to the Delaware Supreme Court:

still raises the commitment issue. Reasoning from existing jurisprudence alone, the solution to the problem is unclear. Professor Regan's analysis requires a breach of fiduciary duty to override the contractual expectation of enforceable deal protection provisions. In the absence of a non-maximizing change-of-control transaction, there is no apparent breach of fiduciary duty in connection with such a provision. In *ACE*, Vice Chancellor Strine found no such breach and was thus only saved from circular reasoning—that is, concluding that deal protections violate fiduciary duty and are therefore invalid because they violate fiduciary duty—by the unusual delegation of board authority to outside counsel in the ACE-Capital Re merger agreement. Because Professor Regan's analytic framework is not particularly apt outside of the change-of-control context<sup>197</sup> and Vice Chancellor Strine's analysis in *ACE* rests upon the thin reed of the anti-disablement principle, neither enables us to draw a firm conclusion regarding the enforceability of deal protection commitments generally.

In the absence of clear theoretical or doctrinal guidance regarding the propriety of a board's precommitment strategy as effected through deal protection provisions, it

With certain exceptions, an informed decision to delegate a task is as much an exercise of business judgment as any other. Likewise, business decisions are not an abdication of directorial authority merely because they limit a board's freedom of future action. A board which has decided to manufacture bricks has less freedom to decide to make bottles. In a world of scarcity, a decision to do one thing will commit a board to a certain course of action and make it costly and difficult (indeed, sometimes impossible) to change course and do another. This is an inevitable fact of life and is not an abdication of directorial duty.

Grimes v. Donald, 673 A.2d 1207, 1214-15 (Del. Sup. Ct. 1996) (citations and internal quotations omitted).

<sup>&</sup>lt;sup>197</sup> Professor Regan makes no such claims for his article, expressly limiting his analysis to the change-of-control context. *See* Regan, *supra* note 180, at 3 (stating that "this Article focuses on the 'bet-the-company' decision by the board of directors of a publicly owned corporation to cause the company to undergo a sale or change of control"). However, Vice Chancellor Strine has sought to extend the analysis to non-change-of-control situations. *ACE*, 747 A.2d 95, at 105 ("Although Professor Regan concentrates on the application of this analysis in the specific context of a corporate change of control ..., the logical force of his analysis is appropriately brought to bear in this context, which ... certainly implicates many of the same policy concerns.").

makes sense to return to the basic policy concern of corporate law: shareholder welfare. How does a board's precommitment to commit to a particular transaction through deal protection devices affect shareholder welfare? Harm to shareholder welfare may constitute sufficient policy grounds for the invalidation of the precommitment. If, on the other hand, deal protections enhance shareholder welfare, courts ought to adopt the opposite approach and uphold the contractual precommitment. In order to answer these questions, it may be useful to set aside the more theoretical issues raised by precommitment and consider the issue with the tools of economic analysis.

#### B. The Economics of Precommitment

Can precommitment strategies benefit targets in merger negotiations?

This section considers the question from a number of perspectives. It draws first upon game theoretic abstractions to evaluate the strategic use of precommitment in merger negotiations. It then considers a handful of more intuitive arguments supporting the value of precommitment as a negotiating tool. Precommitment strategies may be used to credibly convey a party's intentions, to induce would-be acquirors to join or continue negotiations, and to create a commodity with exchange value—that is, certainty. Whether the question is considered from the perspective of abstract economic theory or from the practical perspective of parties engaged in negotiations, precommitment strategies are shown to be a source of value for target companies in merger negotiations.

<sup>&</sup>lt;sup>198</sup> See supra note 15.

#### 1. Fun and Games with NCS

Game theory is a tool for analyzing and understanding strategic behavior. <sup>199</sup> Opportunities for strategic behavior arise from interactions among individuals when each individual's decision depends upon what she expects the others to do. <sup>200</sup> The merger negotiation in *NCS* presented such a situation, with the outcomes for Omnicare, Genesis and NCS depending upon the actions taken by each of the others over the course of the bargaining process. This section applies game theory to the strategic interaction in *NCS*, modeling the merger negotiation as a three party game in an effort better to understand the role of precommitment in merger negotiations.

The factual context arising in NCS can be abstracted into a three player game. Imagine a merger negotiation involving a target, T, a would-be acquiror, A, and an intervening bidder, B. The parties each seek to maximize their own payoffs in connection with the sale or acquisition of T, but the outcome for each depends upon actions taken by the other players. Assume that A and T have been in negotiations and that A is about to make an offer, the first decision in this game. A's choice is to make an offer at or close to the price it actually estimates T to be worth—that is, a bid at its reservation value—or to

<sup>199</sup> See generally Douglas C. Baird, Robert H. Gertner, and Randal C. Picker, Game Theory and The Law (1994) (discussing applications of game theory in law); Drew Fudenberg and Jean Triole, Game Theory (hereinafter Fudenberg & Triole, Game Theory) (1993) (providing textbook discussion of game theory with extensive mathematical modeling); David M. Kreps, A Course in Microeconomic Theory 355-573 (1990) (hereinafter Kreps, Microeconomic Theory) (providing extensive discussion of non-cooperative game theory); David M. Kreps, Game Theory and Economic Modelling (1990) (hereinafter Kreps, Game Theory) (providing a non-mathematical introduction to game theory); Alvin E. Roth, ed., Game-Theoretic Models of Bargaining (1985) (hereinafter Roth, ed., Bargaining) (collecting recent work).

<sup>&</sup>lt;sup>200</sup> BAIRD ET AL., *supra* note XX, at 1 ("Strategic behavior arises when two or more individuals interact and each individual's decision turns on what that individual expects the others to do.").

bid lower, perhaps in preparation for a bidding war. The second decision belongs to B, which must decide whether or not to bid. Finally, T must decide whether or not to accept the highest bid.

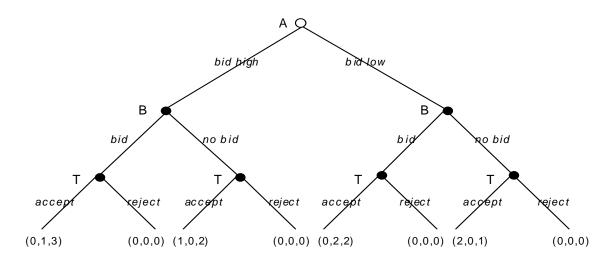
Attaching payoffs to these decisions is somewhat complex because the value of a winning bid depends upon the marginal difference between the winning price and the winner's reservation value. This complexity can be simplified by addressing reservation values instead of price and assuming that all prospective bidders are willing to go up to, but not over, their reservation value, whatever it may be. For purposes of this game, I will also assume that B's reservation value exceeds A's,  $^{201}$  and that each of the parties knows it. 202 Focusing on reservation values rather than actual bid prices allows the parties to be treated on the same payoff scale, where payoffs are modeled as relative departures from each party's unique reservation price. Possible payoffs thus include: no deal (payoff = 0), a deal close to the reservation value (payoff = 1), a deal at a good price (payoff = 2), and a deal at a great price, the likes of which only emerges after a bidding war or, on the buyer's side, when other bidders fail to act (payoff = 3).

Figure 1 presents the parties' possible decisions and their payoffs in an extensive form game.

<sup>&</sup>lt;sup>201</sup> Intervening bidders always place a higher value on the target than is reflected by the initial bid; otherwise they would not enter the contest. This may reflect a higher reservation value than the initial bidder, perhaps due to savings through free-riding. Intervening bidders will not have as many sunk costs in the acquisition—e.g., the expenses of legal and financial advisors and the opportunity costs of executive time—that they will need to recoup in the final deal. The intervening bidder free rides on these costs of the initial bidder.

<sup>&</sup>lt;sup>202</sup> The game, in other words, is one of complete and perfect information. See generally KREPS, GAME THEORY, supra note 199, at 77-87 (discussing importance of distribution of information among the parties and the role of uncertainty in economic modeling). This will not always be a plausible assumption, but in the case of Omnicare and Genesis, Omnicare was a significantly larger company, with greater potential to survive an overbid, and for which preventing the would-be acquiror from completing its acquisition had affirmative value. See supra [or quote case] (discussing value Omnicare placed on preventing a Genesis-NCS transaction).

## Figure 1



Payoffs: A, B, T

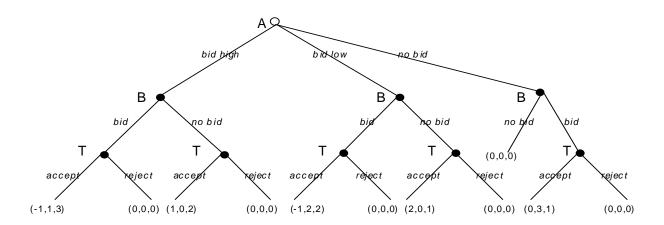
Solving the game by backwards induction,  $^{203}$  one discovers that T will always choose accept because a deal (whether the payoff is 1, 2, or 3) is always better than no deal (payoff = 0). B will always choose bid for the same reason (payoff 1 or 2 > payoff 0), and A, facing a situation where it knows B will always bid and win, will be indifferent to bidding high versus bidding low, since regardless of what it does, it will always lose.

Facing these payoffs, *A* may prefer not to play the game, a preference that is amplified by altering the payoffs to make *losing* bidders suffer a cost. This change in the payoff structure also serves to make the game more realistic. Losing bidders are most

<sup>&</sup>lt;sup>203</sup> Backward induction is a solution technique for extensive form games where, by beginning at each ultimate decision node and making the profit-maximizing choice available to the player making that choice then applying the same technique to the player's decision at each penultimate node and proceeding in like fashion to the initial decision, the play of each player can be predicted. *See* KREPS, GAME THEORY, supra note 199, at 54 (1990) ("Once you know what will happen at all such 'almost-terminal' nodes, you can discover what will happen at 'almost-almost-terminal' nodes, or nodes all of whose successors are either payoffs or almost-terminal. And so on, all the way back to the start of the game.").

obviously harmed by the loss of the expenses they have incurred in pursuit of the acquisition, but worse still, losing bidders are harmed by the signaling effects of a defeated acquisition bid. Defeat at the hands of another bidder may send negative signals regarding the initial bidder's management and financial strength to product and capital markets. This harm to the bidder's reputation may have lasting effects across markets and thus may impact losing bidders considerably more than the loss of sunk costs in connection with the acquisition attempt. Moreover, although losing bidders' sunk costs may be recouped through termination fees and other compensatory lock-up provisions, the reputation costs may linger. The revisions to the game presented in Figure 2 seek to model these costs, imposing a cost (payoff = -1) on A any time A loses the deal as a result of an intervening bid.

### Figure 2



Payoffs: *A*, *B*, *T*.

<sup>&</sup>lt;sup>204</sup> CITATION PENDING.

<sup>&</sup>lt;sup>205</sup> CITATION PENDING.

<sup>&</sup>lt;sup>206</sup> See sources cited in supra note 85 (discussing termination fees and lock-up provisions).

Solving the game in Figure 2 by backwards induction, the above conclusions that T will always choose *accept* and B will always choose *bid* remain undisturbed, but A is no longer indifferent among its available choices. Instead, facing negative outcomes to either of its possible bids,  $^{207}A$  will choose never to enter the bidding rather than entering to take a loss. If A never enters the bidding, B can make a low ball bid, barely above T's reservation value, and win the company. As long as A knows that B will bid and win, then the dominant outcome of *no bid*, *bid*, *accept*,  $^{208}$  with payoffs of 0, 3, 1 to A, B, and T respectively, emerging from the game in Figure 2.

Note that this outcome is not optimal from the target's perspective. It results in the target being sold to a low ball bidder at a barely acceptable price. From the point of view of the target's shareholders, the outcome fails to maximize welfare. Yet as long as *B* can outbid *A* and everyone knows it, this will be the dominant outcome of the game.

The game changes, however, if T is able to participate actively in the bidding process rather than passively accepting or rejecting offers. Empowering T to follow a commitment strategy changes the rules of the game in T's favor by shifting the order of play. If T can precommit by accepting an offer during an early round of bidding, it can control the process, significantly impacting upon the incentives of the competing bidders. The power to precommit is the power to end the game in any round. It solves the problem faced by T in Figure 2, where the target could only stand idly by as stronger bidders discouraged weaker ones from ever entering the process. The power of

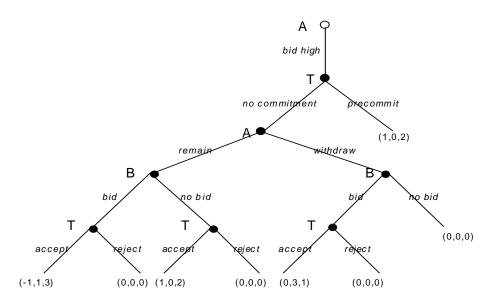
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<sup>&</sup>lt;sup>207</sup> If A bids high and, as expected, B launches an overbid which T accepts, the payoffs to A, B, and T respectively are -1, 1, and 3. If A bids low and B overbids and T accepts, the payoffs are -1, 1, and 2.

<sup>&</sup>lt;sup>208</sup> This outcome is presented in the order of play—i.e., A, B, and T respectively.

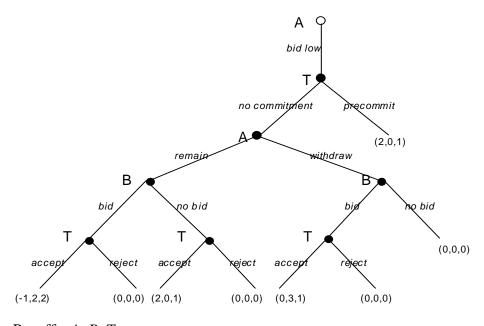
precommitment is illustrated in the extensive form game presented in Figure 3, which is broken into three parts for ease of presentation.

# Figure 3A



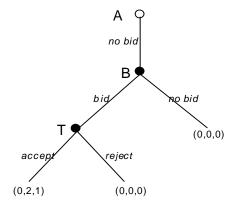
Payoffs: A, B, T.

# Figure 3B



Payoffs: A, B, T.

Figure 3C



Payoffs: A, B, T.

As in the games in Figures 1 and 2, play in the game in Figure 3 opens as A makes the initial decision: bid high, bid low, or walk away. Unlike the previous games, however, where the target was made to stand idly by and watch as bidding developed or failed to occur, T has the second decision. It can either accept A's offer and protect its decisions with precommitment devices, such as those employed by NCS in accepting the Genesis bid, or it can elect not to commit to the initial offer. If T commits—and the courts respect precommitment devices—the game ends. A binding deal has been formed between A and T, and because B has no power to break the commitment, B never bids. If T fails to commit, however, play continues. A must decide whether to respond to T's refusal to commit by withdrawing its offer and walking away or by leaving its offer open and remaining in the process. B then must choose whether or not to bid. And finally, T chooses whether or not to accept the bid on the table. D09 As in the games presented in Figures 1 and 2, we can safely assume that T1 will accept the final offer and that B2, given

<sup>&</sup>lt;sup>209</sup> For ease of presentation, the game is presented with only two bidders in one round of bidding. T's second decision is therefore presented as simple acceptance or rejection since, by assumption, there will be

the chance, will always bid. The payoffs confronting A in response to a decision by T not to commit are thus zero if A walks away before subsequent bidding develops or -1 if it remains involved in the negotiation. One can therefore predict that A will walk away if T fails to precommit. The question thus becomes whether or not T will precommit to A's initial offer.

Having predicted the subsequent decisions of A to walk away and B to bid, T can foresee the probable outcome of its precommitment decision. If A opens with a high bid, T faces likely payoffs of 2 by precommiting and 1 by choosing not to precommit. T will therefore choose to precommit. If A opens with a low bid, however, T will be indifferent between precommiting and allowing the process to continue since either course returns a payoff of 1. Under the third possible scenario—that A will choose to walk away without making an initial offer, as in Figure 3C—there is, of course, no precommitment for T to make, and the next move is B's in deciding whether or not to bid.

The ultimate question, in reasoning through backwards induction, thus becomes whether A will choose bid high, bid low, or no bid. If A bids high, its payoff will be 1 since T will precommit (payoff = 2) and B wll never have the chance to bid (payoff = 0). If A bids low, it cannot predict solely on the basis of T's payoff—which is the same (payoff = 1) regardless of whether it precommits—whether it will receive a payoff of 2 resulting from T's commitment to the low bid or 0 from T's refusal to commit and its own subsequent decision to exit the process.

Precommitment, however, enables *T* to structure *A*'s decision-making in the face of this indeterminacy if, in the course of the negotiation, *T* promises to precommit if and

no subsequent bidding. In either a multiple round game, however, each decision by T is a decision whether to precommit with a binding acceptance.

only if A bids high initially. Unlike most cheap talk in negotiations, <sup>211</sup> this threat is credible because T suffers nothing in carrying it out. As illustrated in Figure 3B, when A bids low, T's payoff will be 1 regardless of whether it precommits to the low bid. If A does not respond to T's threat by bidding high initially, T can retaliate by refusing to precommit and triggering a payoff of 0 rather than 2 for A. Because its T's payoff is unchanged by a decision to retaliate, the retaliation is costless ex post and the threat to do so, therefore, is credible ex ante. In response to T's threat, A should recognize that it is facing a payoff of 1 if it bids high in return for a binding precommitment from T versus a payoff of 0 if it bids low and T retaliates by refusing to precommit and A loses the deal as a result. Because 1 > 0, A should choose bid high in response to this threat. The result of the game modeled in Figure 3, therefore, should be 1, 0, 2. The target gets a good deal, instead being sold, as in the game presented in Figure 2, to a low ball bidder at a barely acceptable price.

The game theoretic modeling in this section has shown that precommitment strategies can improve target shareholder welfare. These models are not meant to suggest that targets *always* maximize welfare by following precommitment strategies. Models

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<sup>&</sup>lt;sup>210</sup> *T*'s promise to precommit if and only if *A* bids high may also be treated as a threat not to commit if *A* fails to bid high. *See generally* Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983) (discussing relationship of threats and promises: "Credible commitments and credible threats share the following common attribute: both appear mainly in conjunction with irreversible, specialized investments. ... [Promises] involve reciprocal acts designed to safeguard a relationship, while [threats] are unilateral efforts to preempt an advantage.").

<sup>&</sup>lt;sup>211</sup> See generally V. Crawford, A Survey of Experiments on Communication via Cheap Talk, 78 JOURNAL OF ECONOMIC THEORY 286 (1998) (INSERT DESCRIPTION/PIN CITE) V. Crawford and J. Sobel, Strategic Information Transmission, 50 ECONOMETRICA 1431 (1982) (discussing role of cheap talk in arriving at equilibrium situations); J. Farrell, Meaning and Credibility in Cheap-talk Games, in M. DEMPSTER, ED., MATHEMATICAL MODELS IN ECONOMICS (1988) (discussing credibility of cheap talk); Joseph Farrell & Robert Gibbons, Cheap Talk Can Matter in Bargaining, 48 J. ECON. THEORY 221, 222-23 (1989) (modeling a two party negotiation and finding that cheap talk conveys information, changes outcomes, and also that "some outcomes of the 'talk' stage lead to second-stage bidding strategies that could not be equilibrium strategies absent the changes in beliefs that the talk causes").

are simplifications, and the more their simplifying assumptions are relaxed, the more difficult it becomes to predict outcomes from them. In the games presented above, the assumption of complete and perfect information enabled the prediction of behavior on the basis of a simple set of payoffs. <sup>212</sup> If, relaxing the assumption, the players are uncertain of their competitors' reservation values and costs, then the behavior of each will depend on its own best estimate of the others' payoffs and the parties' ability to signal intentions to each other, complicating the model considerably. <sup>213</sup>

Even so, commitment strategies have many applications in situations of incomplete information. In the words of Schelling:

"If each does not know the other's true reservation price there is an initial state in which each tries to discover the other's and misrepresent his own, as in ordinary bargaining. But the process of discovery and revelation becomes quickly merged with the process of creating and discovering commitments; the commitments permanently change, for all practical purposes, the "true" reservation prices. If one party has, and the other has not, the [ability to make a binding commitment], the latter pursues the "ordinary" bargaining technique of *asserting* his reservation price while the former proceeds to *make* his. <sup>214</sup>

Commitments enhance the ability of parties to convey information to other players and, in doing so, to alter their behavior.<sup>215</sup> Without the ability to hold to a predetermined

<sup>&</sup>lt;sup>212</sup> See, e.g., Kalyan Chatterjee, *Disagreement in Bargaining: Models with Incomplete Information*, in ROTH, ED., BARGAINING, supra note 199, at 9-26 (providing an introduction to recent work in non-cooperative models of bargaining under incomplete information); FUDENBERG & TIROLE, GAME THEORY, *supra* note 199, at 250-53, 397-416 (1993) (discussing auctions in the context of mechanism design and non-cooperative bargaining theory under conditions of imperfect information).

<sup>&</sup>lt;sup>213</sup> Although it is obvious that competing bidders rarely have full information regarding the reservation value of the other, it may not be much of a stretch to assume that with the assistance of investment bankers and publicly available financial information, sophisticated bidders may be able to make a reasonably close guess as to the value their competitors place on the target. The probability estimate involved in games of incomplete information may be modeled as a Bayesian equilibrium. *See generally* FUDENBERG & TIROLE, *supra* note 199, at 209-40 (1993).

<sup>&</sup>lt;sup>214</sup> THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 27 (1960).

<sup>&</sup>lt;sup>215</sup> See FUDENBERG & TIROLE, supra note 199, at 75:

course of action, a player does not have the same credibility in communicating its intentions to other participants and, as a result, will also have less opportunity to influence their behavior. Generals burn bridges behind them in order to signal to the enemy that they will not retreat. In doing so, they imperil themselves should retreat become necessary, but the commitment itself—the intractable promise not to retreat—may alter the enemy's will to fight. <sup>217</sup>

The goal of the modeling in this section has been to illuminate the role of precommitment in merger negotiations. Precommitment empowers the target, effectively altering the order of play by giving the target the power to end play after each round of bidding and, equally importantly, the power to *threaten* to end bidding at the end of each round. In the game presented in Figure 3, *T* increases its shareholders' wealth by precommiting to a high bid and by using the threat/promise of precommitment to induce *A* to lead with a high bid, thus demonstrating one situation in which a precommitment strategy plainly improves shareholder welfare.<sup>218</sup> These uses of precommitment are

[C]ommitments can be of value, since by committing himself to a given sequence of actions a player may be able to alter the play of his opponents. This 'paradoxical' value of commitment is closely related to [the] observation... that a player can gain by reducing his action set or decreasing his payoff to some outcomes, provided that his opponents are aware of the change.

Id.

<sup>&</sup>lt;sup>216</sup> Commitments enable sellers to communicate credibly their bottom line price and force would-be hagglers into a take-it-or-leave it strategy. *See* Carl Ehrman & Michael Peters, *Sequential Selling Mechanisms*, 4 ECON. THEORY 237, 239 (1994) (comparing the efficiency of fixed price sales and simple auctions from the seller's point of view and finding that "a simple auction is never optimal for the seller"); John Riley & Richard Zeckhauser, *Optimal Selling Strategies: When to Haggle, When to Hold Firm*, 98 Q. J. OF ECON. 267, 270 (1983) (comparing fixed price sales to simple auctions and finding that the ability to commit to a firm price is of value to the seller because it enables them to establish a selling mechanism "whereby a refusing buyer is shown the door and the next buyer is called in")

<sup>&</sup>lt;sup>217</sup> Cf. Kahan & Rock, Corporate Constitutionalism, supra note XX [at 36] (noting that "a precommitment is only as strong as the obstacles to subsequent reversal" and therefore that "if there is to be judicial intervention, it must be highly selective: otherwise, the attempt to rescue shareholders ex post will destroy the value of the commitment ex ante").

<sup>&</sup>lt;sup>218</sup> In the model, the target shareholders' payoff increased from 1 to 2.

available only in a world where precommitment is possible—that is, where the law respects precommitment devices. If, as the Delaware Supreme Court did in *NCS*, courts refuse to recognize precommitment devices, effectively eliminating precommitment as a negotiating strategy, suboptimal outcomes for target shareholders will follow.

## 2. Certainty as a Valuable Trading Commodity

Although game theory may be a useful source of insight in thinking through the value of precommitment in negotiation, it may seem a bit abstract. Fortunately, there are several more intuitive arguments supporting the value of precommitment strategies. A firm commitment on the part of the target may provide the inducement necessary to bring a would-be acquiror to the bargaining table, and once the would-be acquiror is at the table, targets may be able to use the ability to commit as a bargaining chip for a higher price or other concessions from the acquiror.

A firm commitment strategy may be necessary to bring a reluctant bidder to the table. Putting together a merger proposal is expensive in terms of time, money, and reputation. A bidder that is willing to go to this expense will want to ensure, if it submits the best proposal, that it will be able to consummate a transaction. Deal protections enable targets to make this commitment.<sup>219</sup> Without the ability to do so, targets may not

<sup>219</sup> See Hanewicz, Golden, supra note 84, (noting that buyers request deal protections because such provisions increase the likelihood "that the deal will be consummated by reducing the risk that it will be broken up by subsequent bidders"); Stephen R. Volk, Lewis H. Leicher & Raymond S. Koloski, Negotiating Business Combination Agreements - The "Seller's" Point of View, 33 SAN DIEGO L. REV. 1077, 1078 (1996) (discussing acquisition agreements from the target's point of view and noting that deal protections arise "at the buyer's request in order to reduce the likelihood of a third party interfering with the contemplated transaction").

be able to entice would-be acquirors to begin negotiations, leaving targets with a lesser (and potentially worse) set of options.<sup>220</sup>

From this perspective, the choice facing NCS directors when they agreed to the Genesis demand for strong deal protections was not *take this deal* versus *wait for a superior bid*. Rather, it was *take this deal* versus *wait for a potentially worse one and, quite possibly, no deal at all*. Recall that at the time of negotiations, the then-current Omnicare proposal—essentially a low-ball bid for NCS assets in bankruptcy—was plainly inferior to the Genesis proposal. Genesis expressed interest but refused to be treated as a stalking horse. Under the majority's rule, NCS would have been forced to respond that it could only offer limited contractual protection since it was required by law to include a fiduciary out. While it is impossible to know what would have happened under these circumstances, Genesis might well have walked away, leaving NCS with only Omnicare's inferior bankruptcy bid. Thus, from the *ex ante* perspective, the NCS shareholders plainly would have been worse off.

If the inability of targets to commit to a particular transaction does not keep potential bidders entirely away, it will almost certainly cause them to bid less. Although it is bidders who will negotiate for exclusivity to avoid the costs of uncertainty,

<sup>&</sup>lt;sup>220</sup> See Jewel Cos. v. Pay Less Drug Stores Northwest, Inc., 741 F.2d 1555, 1563 (9<sup>th</sup> Cir. 1984) (enforcing deal protection provisions guaranteeing exclusivity for a merger agreement and noting: "A potential merger partner may be reluctant to agree to a merger unless it is confident that its offer will not be used by the board simply to trigger an auction for the firm's assets. Therefore, an exclusive merger agreement may be necessary to secure the best offer for the shareholders of a firm."). Accord Cramton & Schwartz, Auction Theory, supra note XX, at 41 (noting that although the "existence of sunk costs in the acquisition context ... permits target boards to engage in ex post opportunism," if "bidders anticipate this... strategy... the auction could unravel" and "no one would enter").

<sup>&</sup>lt;sup>221</sup> Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*16 (Del.S.Ct. Apr. 4, 2003).

<sup>&</sup>lt;sup>222</sup> Once again Chief Justice Veasey has said as much in his dissent. *Id.*, at \*82 (Veasey dissenting) ("The NCS board... did not know if the NCS business prospects would have declined again, leaving NCS less attractive to other bidders, including Omnicare, which could have changed its mind again and insisted on an asset sale in bankruptcy.").

ultimately it is not bidders who will bear the costs of uncertainty. Instead, these costs will be passed back to targets as would-be bidders adjust the price they are willing to pay for the target. Of course, this will be a downward adjustment, reflecting the "uncertainty discount," borne by all targets in jurisdictions where targets cannot make firm commitments to a particular transaction. Deal protections, on the other hand, induce prospective bidders to the bargaining table and reduce the size of the uncertainty discount. Limiting the ability of directors to employ these provisions is likely to harm target shareholders *ex ante*. 225

In addition to inducing bidders to the table and limiting the uncertainty discount, transactional certainty is an item of value that targets may offer acquirors in exchange for an increase in price or other concessions in the merger agreement. A set of deal protections is a "commodity with value" that can be traded during negotiations for commodities with value, such as cash. As Chief Justice Veasey noted in his dissent, the exchange value of transactional certainty may be high:

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<sup>&</sup>lt;sup>223</sup> See Bainbridge, Exclusive Merger Agreements, supra note 85, at 283 (noting that "rational bidders presumably discount their bids to account for the risk that the target board will renege"); Johnson & Siegel, Mergers, supra note 80, at 365, n.170 ("An acquiring company predicates its offering price upon (1) the value of the target, and (2) risks involved in attempting the acquisition.").

<sup>&</sup>lt;sup>224</sup> See Hanewicz, Golden, supra note 84, at 208 (analogizing the deal process to selling a home: "If the seller cannot credibly commit to selling his house at a certain price, the buyer may not enter into the transaction or may lower his initial bid and wait to see if another offer emerges."); Paul K. Rowe, The Future of the "Friendly Deal" in Delaware, 31 (July 10, 2000) (unpublished manuscript, on file with author) ("[H]ow many deals will be announced at less attractive exchange rates for the side believed to be vulnerable to an overbid; so that the bidder can keep some powder dry?").

<sup>&</sup>lt;sup>225</sup> Accord Renaissance Communications Corp. v. NBC, Inc., C.A. No 14446, 1995 WL 1798510, at 14 (Del. Ch., Aug. 1, 1995) (Allen, C.) (arguing that "it is self-defeating for the fiduciary law to say in all events a higher and later price gives rise to a fiduciary obligation to breach the contract").

<sup>&</sup>lt;sup>226</sup> Hanewicz, *Golden*, *supra* note 84, at 232 (describing that "a target does not unilaterally enact a no-shop, but instead agrees to the buyers demand for one in exchange for something of presumably equal value from the buyer, such as an increase in price or a concession on another part of the agreement); Johnson & Siegel, *Mergers*, *supra* note 80, at 406-407 (noting that a covenant protecting the deal is a "commodity with value" and that acquirors "should theoretically pay more if such a covenant is a part of the merger agreement").

Certainty itself has value. The acquirer may pay a higher price for the target if the acquirer is assured consummation of the transaction. The target company also benefits from the certainty of completing a transaction with a bidder because losing an acquirer creates the perception that a target is damaged goods, thus reducing its value. 227

This is exactly how the NCS board used certainty, going back to Genesis at the last minute for an increase in consideration, and agreeing to the deal protections only after receiving an increase in price. <sup>228</sup> In other words, Genesis and NCS "exchanged certainty" as an element of their bargain and as a valuable part of their deal, not as a response to a hostile threat.

Unfortunately, the majority opinion in *NCS* appears to take the commodity-value of certainty away from target boards.<sup>229</sup> Worse still, the loss of the ability to trade certainty also eliminates the ability of target boards to follow precommitment strategies and credibly convey their intentions in negotiation. As shown above, this is likely to lead to sub-optimal outcomes. To generalize slightly, the *NCS* decision takes away the ability of targets to control the merger process and drives up transaction costs by eliminating valuable negotiating alternatives. One ought not to be surprised if, as a result, target companies on the whole sell for less.

## V. Controlling the Costs of Commitment: Market Checks in the Last Period

Situations will arise where business realities demand a lock-up so that wealth-enhancing transactions may go forward. Accordingly, any bright-line rule prohibiting lock-ups could, in circumstances such as these, chill otherwise permissible conduct.

Id., at \*82 (Veasey, dissenting).

<sup>&</sup>lt;sup>227</sup> Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*80 (Del.S.Ct. Apr. 4, 2003) (Veasey dissenting).

<sup>&</sup>lt;sup>228</sup> *Id.*, at \*23-26.

<sup>&</sup>lt;sup>229</sup> In Chief Justice Veasey's words:

The preceding section should not be taken to suggest that precommitment strategies always promote shareholder welfare or to advocate an alternative rule of bland deference to deal protection provisions. A focus on the benefits of precommitment ought not to blind us to the possible costs.

Fundamentally, deal protections increase target directors' control over the acquisition process, enabling them to maximize shareholder returns, but also increasing their opportunity to commit to a transaction that puts their own interests ahead of those of their shareholders. Large scale acquisition transactions, in particular, may create strong incentives for target directors to act in pursuit of their own selfish interests because such transactions throw target directors and managers into a last period problem.<sup>230</sup>

Last period problems arise when the participants in a cooperative enterprise suddenly realize that their collaborative endeavor has a finite time horizon. As the end approaches, each participant's incentives towards selfless cooperation in pursuit of the goals of the enterprise predictably deteriorate and are replaced by increasing incentives towards self-interested behavior. 231 Such incentives are manifest in a number of our

<sup>&</sup>lt;sup>230</sup> See Sean J. Griffith, Deal Protection Provisions in the Last Period of Play, 71 FORDHAM L. REV. 1899,

<sup>1946 (2003) (</sup>hereinafter Griffith, Deal Protections) ("The last period problem ... exists as an ex ante structural concern each time the management team of a target firm faces restructuring following a prospective acquisition."). See also Jennifer H. Arlen and William J. Carney, Vicarious Liability For Fraud On Securities Markets: Theory and Evidence, 1992 U. ILL. L. REV. 691 (1992) (last period problem in securities fraud); Donald C. Langevoort, Capping Damages for Open-Market Securities Fraud, 38 ARIZ. L. REV. 639 (1996) (last period problem in securities fraud); Rose-Ackerman, Risk Taking, supra note 102 (last period problem in bankruptcy).

<sup>&</sup>lt;sup>231</sup> See generally FUDENBERG & TIROLE, supra note 199, at 166 (explaining that "the scheme of selfreinforcing rewards and punishments used in the folk theorem can unravel backward from the terminal date" and noting that "with a fixed finite horizon 'always defect' is the only subgame-perfect-equilibrium outcome" as well as the only Nash outcome); KREPS, GAME THEORY, supra note 199, at 70 (stating that "[i]f at the start of any round the two players involved know that this is the last, then [player] A will certainly exploit [player] B given the opportunity—no point in protecting a reputation if there are no further opportunities to use that reputation"); John O. Ledyard, Public Goods: A Survey of Experimental Research,

commonly held intuitions regarding human behavior, including the landlord's suspicion that tenants may skip out on their final month's rent and the possibility that temporary or short term employees may shirk. Acquisitions create a last period scenario for target managers and directors because the reorganization of the corporate structure following the transaction is likely either to end their tenure or, at the very least, significantly change their role in the company. With the alteration or elimination of their corporate responsibilities come increased incentives to defect from the best interests of the corporation and its shareholders in favor of their own interests. Or, to put it somewhat crassly, outgoing managers and directors are more likely to be motivated to get what they can while they can. As a result, target managers and directors may favor a particular merger because it includes generous side payments<sup>232</sup> or because it allows them to continue in the management of the continuing corporation.<sup>233</sup>

Deal protection provisions are troubling precisely because they permit target managers and directors to insulate their last period decisions, already freed from the mid-

in THE HANDBOOK OF EXPERIMENTAL ECONOMICS 142, TBL. 2.9 (summarizing research showing a significant drop in cooperation from the first period to the last).

[A]ssume the LMN board proposes a merger with a 60/40 equity split favoring ABC's stockholders. The LMN board, however, insists on assuming full managerial control over the combined corporation and will terminate ABC's directors and management. The XYZ board, on the other hand, offers a 50/50 equity split, but plans to double the size of the board for the combined entity, thus preserving the jobs of each director and resulting in co-chief executive officers and co-chairpersons of the board.

...[I]t is ... possible that ABC's board has accepted the XYZ offer out of self-interest. Lebovitch & Morrison, *Duck, supra* note 105, at 13-14.

<sup>&</sup>lt;sup>232</sup> See, e.g., Edward B. Rock and Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1662 (2001) (noting that "if one can get seriously rich, one can move to Aspen and ski for the rest of one's days").

<sup>&</sup>lt;sup>233</sup> Given a choice between two deals, directors may favor the deal that serves their own interests over shareholder interests. For example:

stream constraints associated with the ongoing management of a business entity, <sup>234</sup> from the disciplinary effects of the market for corporate control. 235 By pursuing a negotiated acquisition, rather than resisting a hostile takeover, target directors are not subject to Revlon duties to maximize short term consideration, <sup>236</sup> and are therefore free to pursue a deal with a favored bidder rather than necessarily selling to the highest bidder. Given last period temptations to get what they can while they can, there is some risk in this situation that target directors will favor deals that, through side payments or other arrangements, maximize director or manager welfare rather than corporate or shareholder welfare. Such selfish and self-serving deals are likely to attract the interest of competing bidders. Because the price of the target company in a self-serving deal does not fully reflect the target's value, competing bidders will be attracted to the apparent bargain.<sup>237</sup> In an active control market, competing bidders will make offers for the company that push the price up, exposing the initial transaction as sub-optimal and revealing the target directors as self-serving, ultimately giving target shareholders reason to reject the sub-optimal transaction in favor of the premium bid.

The point of deal protections, however, is to deter premium bids, thus enabling the target board to move forward with a potentially self-serving deal. Deal protections

234 A corporation manager's mid-stream constraints include product markets, capital markets, labor

markets, and the norms developed within the firm to guide management conduct. See generally See generally Rock & Wachter, supra note XX, at 1642 (discussing the role of "non-legally enforceable rules and standards" in structuring behavior within an organization); Robert B. Thompson, The Law's Limits on Contracts in a Corporation, 15 J. CORP. L. 377, 379 (1990) (arguing that the mutability of corporate law rules should depend on the effectiveness of the "nexus of constraints" within a corporation).

<sup>&</sup>lt;sup>235</sup> See supra note 70.

<sup>&</sup>lt;sup>236</sup> See supra Part II.B.1.

<sup>&</sup>lt;sup>237</sup> Self-serving deals involve the diversion, from shareholders to directors and managers, of some portion of the overall deal consideration. Such deals will appear as bargains to competing bidders because the diverted consideration diverted will not be a part of the announced price for the target. A company that

insulate transactions from the market for corporate control. The level of protection may vary—from a simple no-shop provision that merely prohibits outgoing solicitations of interest to the completely protected agreement in *NCS* created by the voting lock up and the must submit clause—but the general effect of all such provisions is to reduce the likelihood that other bidders will interfere with a chosen transaction. Such insulation may be used either to serve shareholder welfare, as we saw in the previous section—to enact a welfare-enhancing commitment strategy—or, as we now see, to maximize director and manager welfare—to shield self-serving decisions made in management's last period of play.

Although the last period problem thus raises serious concerns regarding protected merger agreements, it necessitates neither the *per se* invalidation of deal protection provisions nor extensive judicial intervention to separate good deal protections from bad ones. As I have argued elsewhere, there is a structural solution to these concerns. This is the market check rule, sketched below. The greatest error of the *NCS* majority was to fail to recognize that the market check constraint was, in fact, operational in the NCS-Genesis transaction and, as a result, to craft an additional constraint on directors that, due to its inflexibility, is likely to reduce shareholder welfare.

A target corporation engages in a market check by soliciting the interest of wouldbe acquirors. The check can be done privately, through investment bankers, or publicly, through an announcement or other signal that that alerts the control market of the target's

would optimally sell for \$100, for example, will appear to sell for \$87 if \$13 is diverted to selfish managers. Competing bidders may thus be attracted by the apparent bargain.

<sup>&</sup>lt;sup>238</sup> See Griffith, Deal Protections, supra note XX (discussing the market check as a solution to the last period problem in the context of protected merger agreements).

potential interest in a transaction.<sup>239</sup> Market checks may be conducted prior to agreeing to a particular deal (a pre-signing market check) or, if provision is made in the agreement, after signing a deal (a post-signing market check). In all cases, however, the point of the market check is to test the interest of other potential bidders in the target and, in doing so, to provide a realistic estimate of the terms the target might receive in an eventual sale.

More broadly, a market check inserts constraints into what might otherwise be an unconstrained last period decision by reintroducing the market for corporate control into the merger process. Boards will not *mistakenly* agree to a sub-optimal deal beause the solicitation of other bids will either result in an overbid or cause the initial bidder to offer a higher price to avoid attracting other bidders to an apparent bargain. Boards will also be constrained from selfishly agreeing to a sub-optimal deal because the emergence of an overbid will put significant pressure on a self-serving board. Although, under the current change-of-control paradigm, <sup>240</sup> boards are under no duty to accept the highest bid to arise in the market check, the mere possibility of a competing bid constrains the board from entering into sub-optimal deals by threatening to expose the selfishness of the target board to public scrutiny. The appearance of a higher bid in the market check process would plainly inform the board, the public, and (potentially) the court that the originally intended transaction is not optimal. Because at least some members of the board of directors are likely to take seriously their charge to promote shareholder welfare, public evidence that they have failed to do so may cause them to re-evaluate the terms of a favored transaction and, prospectively, to keep them from entering sub-optimal

<sup>239</sup> See, e.g., In re IXC Communications, Inc. Shareholders Litigation, 1999 Del. Ch. LEXIS 210, at \*15 (Del. Ch., Oct. 27, 1999) (endorsing solicitation process where target announced to the universe of possible transaction partners that it would consider bids for sale or merger but did not make outbound solicitations).

transactions in the first place. Loyal disinterested directors are thus likely to insist that the terms of their chosen deal approach the terms of the optimal deal, even though there is no *Revlon* duty to maximize the consideration paid in the deal. Moreover, the emergence of a premium bid as the result of a market check may cause shareholders, when they vote on the merger, <sup>241</sup> to reject the sub-optimal deal.

Where there has been a market check, and thus a reinsertion of the constraining influence of the market for corporate control on what might otherwise be an unconstrained last period decision, the court can apply business judgment deference to the decision of the board to commit to a particular deal and protect its decision in the merger agreement. Thus, in its most basic formulation, a "market check rule" might state that, provided there is no specific evidence of self-dealing, the presence of a good faith market check frees the target board to follow an affirmative precommitment strategy.

Following the fact specific nature of the Delaware corporate law, the exact contours of the market check rule are best left to be developed by the Delaware courts in the context of specific disputes. However, some general remarks about the rule's doctrinal origins and practical operation may be useful in guiding that development. It is worth emphasizing initially that this seemingly novel approach turns on one of the oldest principles in corporate law—good faith. Regardless of whether it is treated as a distinct fiduciary duty, <sup>243</sup> good faith has a well established doctrinal basis and effect. A board

<sup>&</sup>lt;sup>240</sup> See supra Part II.B.1.

<sup>&</sup>lt;sup>241</sup> Again, it is worth pointing out that although the NCS shareholders would vote, the outcome was a foregone conclusion given the voting agreements of a majority of shareholders. As discussed below, the market check in *NCS* made strong deal protections, including a locked-up shareholder vote, appropriate. *See infra* [ ].

<sup>&</sup>lt;sup>242</sup> See Rock, supra note XX.

<sup>&</sup>lt;sup>243</sup> See supra note 1.

that does not act in good faith does not act in fulfillment of its duty to shareholders and may not receive the deference of the business judgment rule. Although it is not easy to define good faith,<sup>244</sup> a number of recent cases suggest that it focuses on the state-of-mind or intent of directors and may be drawn into question by facts supporting an inference that the board has put some other interest ahead of its shareholders.<sup>245</sup> Good faith is arguably the core issue in *Unocal* and its progeny. What else is the "omnipresent specter" other than an increased risk that the board is putting another interest (its own) ahead of the interests of its shareholders?<sup>246</sup> Furthermore, good faith is the underlying concern in the context of a negotiated transaction where we are suspicious that directors may be seeking self-serving side deals rather than the best deal for the corporation and its shareholders.<sup>247</sup>

When a market check is conducted in good faith—that is, when directors solicit offers in a genuine attempt to find the best deal for the corporation—the court can be confident that the resulting deal is not a product of the board's selfish parochial interests. It is thus not worth specifying the exact procedures of the market test—for example, whether a market test must use investment bankers or publish a solicitation of interest or merely canvass known players in a particular industry—since the validity of the test will be a fact-specific question depending not on the procedures of the test but on the good

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<sup>&</sup>lt;sup>244</sup> CITATION PENDING. TO SAY THAT GF APPEARS TO LIE IN BETWEEN THE OTHER TWO MORE RIGID DOCTRINAL CATEGORES. IS NOT CONFLICT TRANSACTION, DOL, NOR IS IT SUBSTANTIVE DUE CARE, DOC. REQ'T OF SOM.

<sup>&</sup>lt;sup>245</sup> Such facts apparently include an extremely poor and otherwise inexplicable substantive outcome. *See*, *e.g.*, In re: Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795 (2001) (finding evidence to support an inference that the board failed to act in good faith on the basis of an extremely poor, from the corporation's point of view, substantive outcome); In re the Walt Disney Company Derivative Litigation, 825 A.2d 275 (Del. Ch. May 2003) (same).

<sup>&</sup>lt;sup>246</sup> See supra note 67 and accompanying text.

faith of the directors engaging in the test. The market mechanism of competing bidders will force up the price and prevent sub-optimal sales as long as the market check is conducted in good faith. If, on the other hand, the market test has not been conducted in good faith, we can have no confidence in its ability to awaken the control market as a constraint on director conduct. A board that has engaged an investment bank to solicit bidders but that has given secret instructions to the bank not to solicit a particular competitor or that has manipulated the information strategically to discourage premium bidders will not have acted in good faith, and a court ought not to defer to their process but rather to scrutinize the terms of the resulting transaction. In this way, the structural solution to the problem of protected deals ultimately turns on arguments about the good faith of the board in conducting its market test.

Boards wishing to protect their deals and avoid enhanced scrutiny will engage in a market check. Without a market check, a board ought not to be entitled to judicial deference under the business judgment rule since the otherwise unconstrained last period problem suggests that directors may be agreeing to the deal in bad faith. Defendant directors ought to be made either to rebut this inference of bad faith, thereby reestablishing the business judgment rule, or to face enhanced scrutiny of the transaction as a whole. Where there has been a market check, however, the presumption should be in favor of the directors' good faith. Shareholder plaintiffs could rebut this presumption by showing that the market check was not conducted in good faith, perhaps by supplying evidence of the limiting instructions suggested above. But if the plaintiff cannot draw the good faith of the market check into question, the transaction and the deal protection

<sup>&</sup>lt;sup>247</sup> See generally Manne, Mergers, supra note 70, at [PIN CITE] ("When we find incumbents recommending a control change, it is generally safe to assume that some side payment is occurring").

provisions shielding it ought to be accorded judicial deference under the business judgment rule, as a good faith business decision of the board.

The proposed market check rule is superior to the NCS majority's *per se* rule against transactional certainty. Because it is narrowly tailored to the specific concerns arising from deal protection, it promotes shareholder welfare by allaying the concern that boards will serve themselves more than their shareholders while also preventing the welfare loss associated with a flat prohibition of precommitment strategies. Moreover, the market check rule is less of a departure from existing corporate law doctrine than the decision of the *NCS* majority.<sup>248</sup>

A number of Delaware decisions seem implicitly to follow the market check rule. The principles underlying the rule reconcile and explain the apparently inconsistent outcomes of four recent Chancery Court decisions—two of which held that where the target boards had not engaged in a market check, the court would be inclined, if it reached the issue, to invalidate the deal protections embedded in the merger agreement, while two others held that where the target board had engaged in some form of a market test, business judgment deference was appropriate. The market check rule may have deeper origins, however, arguably having grown out of the Delaware Supreme Court's notorious *Van Gorkom* decision. Although that decision is sometimes misinterpreted to mandate particular procedural steps in agreeing to an

<sup>248</sup> See supra Part III (discussing the arguments and doctrinal authority relied upon by the majority).

<sup>&</sup>lt;sup>249</sup> Griffith, *Deal Protections*, supra note XX.

<sup>&</sup>lt;sup>250</sup> See Phelps Dodge Corp. v. Cyprus Amax Minerals Co., 1999 Del. Ch. LEXIS 202 (Del. Ch., Sept. 27, 1999); ACE Ltd. v. Capital Re Corp., 747 A.2d 95 (Del. Ch., Oct. 28, 1999).

<sup>&</sup>lt;sup>251</sup> See State of Wisconsin Investment Board v. Bartlett, C.A. No. 17727, 2000 Del. Ch. LEXIS 42 (Del. Ch. Feb. 24, 2000); In re IXC Communications, Inc. Shareholders Litigation, 1999 Del. Ch. LEXIS 210 (Del. Ch., Oct. 27, 1999).

acquisition, such as the inclusion of an investment banker's fairness opinion and a target board meeting that lasts longer than two hours, <sup>253</sup> a better reading of the opinion—or at least of the Court's concerns underlying the opinion—would emphasize the last period problem faced by almost every member of the Trans Union management team and the apparent lack of constraint on management's ability to act in pursuit of its own self interest. <sup>254</sup> The reliance of the *Van Gorkom* Court on procedure may thus be read as the Court striving for some means to reinsert a constraint on the last period decision-making of target management. This is the precise function of the proposed market check rule.

Sadly, the *NCS* majority failed to recognize this nascent line of doctrine and the superiority of the flexible market check rule to the rigidity of either *per se* deference or *per se* invalidation. The facts in *NCS* provided a perfect opportunity to endorse the market check rule. Prior to signing the merger agreement with Genesis, NCS had solicited the interest of over fifty prospective bidders. It engaged in active negotiations with both Genesis and Omnicare, and agreed to a precommitment strategy only after extracting further concessions, including an increase in price, from Genesis.

Furthermore, there was no hint of self-interest on the part of the NCS board.

Unfortunately, the narrow focus on the *ex post* difference in consideration between the

The directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the 'sale' of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the 'sale' of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency.

Id., at 874.

<sup>&</sup>lt;sup>252</sup> Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

<sup>&</sup>lt;sup>253</sup> *See id.*, concluding that:

<sup>&</sup>lt;sup>254</sup> See Griffith, Deal Protections, supra note XX, at 1953–1962.

<sup>&</sup>lt;sup>255</sup> See supra text accompanying notes 18-32.

final Genesis and Omnicare bids apparently caused the three Justice majority to miss the key facts of the case and, in doing so, to craft a plainly sub-optimal rule.

The dissent, however, did view the process as a whole and did seize on the key fact of the good faith market check. Justice Steele, who in his previous position as a Vice Chancellor on the Court of Chancery, wrote two of the Chancery Court opinions implicitly following the market check rule, <sup>256</sup> drew particular attention to the fact that the NCS board had acted selflessly after "thoroughly canvassing the market" for other bidders. He pressed the point, arguing that where the board has acted unselfishly and in good faith, a precommitment strategy used to entice a merger partner into a transaction and increase the consideration paid to shareholders ought not to be invalidated by courts:

We should not encourage proscriptive rules that invalidate or render unenforceable precommitment strategies negotiated between two parties to a contract who will presumably, in the absence of a conflicted interest, bargain intensely over every meaningful provision of a contract after a careful cost benefit analysis. <sup>258</sup>

Chief Justice Veasey also emphasized the "lengthy search and intense negotiation process" engaged in by NCS in agreeing to their deal. Because the majority's bright-line rule takes the precommitment strategy away from boards in favor of a requirement that boards retain the opportunity to commit "efficient breach," the dissenting Justices

<sup>&</sup>lt;sup>256</sup> See State of Wisconsin Investment Board v. Bartlett, C.A. No. 17727, 2000 Del. Ch. LEXIS 42 (Del. Ch. Feb. 24, 2000); In re IXC Communications, Inc. Shareholders Litigation, 1999 Del. Ch. LEXIS 210 (Del. Ch., Oct. 27, 1999). For a discussion of these opinions in the context of other Chancery decisions on deal protections, see *supra* note XX.

<sup>&</sup>lt;sup>257</sup> Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*98 (Del.S.Ct. Apr. 4, 2003) (Steele, dissenting). In discussing the unselfish good faith of the NCS directors, the Court emphasized that there was no evidence of "insidious, camouflaged side deals for the directors… nor transparent provisions for entrenchment or control premiums." *Id.*, at \*99 (Steele, dissenting).

<sup>&</sup>lt;sup>258</sup> *Id.*, at \*99-100 (Steele, dissenting).

<sup>&</sup>lt;sup>259</sup> *Id.*, at \*75 (Veasey, dissenting).

<sup>&</sup>lt;sup>260</sup> *Id.*, at \*107 (Steele, dissenting) ("Does the majority mean to signal a mandatory, bright line, *per se* efficient breach analysis *ex post* to all challenged merger agreements?"). Given the ex ante costs of ex post

strongly argued that the Court overstepped its bounds by invalidating board decision-making that was conducted "in good faith, free of self interest, after exercising scrupulous due care."<sup>261</sup>

Thus although the majority adopted a rule in *NCS* that is probably not in the best interests of target shareholders on the whole, the dissenting Justices' emphasis on the deal-making process and, in particular, on the NCS board's market check suggests some level of awareness by the Court that there may be a more subtle structural solution to the genuine issues presented by well-protected merger agreements. The structural solution of the market check rule addresses the legitimate concerns associated with precommitment without the welfare losses associated with a flat prohibition of transactional certainty. The market check rule constrains the self-interest of target directors in an otherwise unconstrained last period scenario by reinserting the influence of the market for corporate control. At the same time, the market check rule permits directors who have tested the control market to follow a precommitment strategy. Although the Court missed the opportunity to endorse the market check rule in *NCS*, the proposed rule may provide a promising avenue of retreat from the Court's bright line rule against precommitment.

## VI. Conclusion

Following the tendency of Delaware corporate law to break issues into dichotomies, this article has sought to analyze the Delaware Supreme Court's opinion in

breach, what is referred to here as "efficient breach" is perhaps better described as "opportunism." *See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47-49 (1985) (distinguishing between self-interest and opportunism); OLIVER E. WILLIAMSON, THE MECHANISMS OF GOVERNANCE 47-48 (1996) (noting effect of opportunism on efficiency analysis).

NCS in two ways. First, the article focused on doctrinal aspects of the majority's opinion, focusing both on how the majority applied existing doctrine in the area of mergers and acquisitions and on how the Court's decision may change those doctrinal paradigms. This analysis revealed that the Court was not compelled by existing Delaware law to reach its conclusion. The factual situation in NCS was controlled by neither Unocal and Time Warner nor QVand Quickturn. The Court was therefore free to fashion a new rule appropriate to the context of deal protection provisions in friendly merger agreements.

Unfortunately, in settling on its bright line rule against transactional certainty, the majority did not choose a rule that is likely to maximize the welfare of target shareholders. The second function of this article was thus to engage in a close examination, through the lens of shareholder welfare maximization, of the costs and benefits of transactional certainty and precommitment strategies. Having found value in both certainty and commitment, this analysis shows that the *NCS* rule is likely, on the whole, to harm target shareholders by taking these sources of value away. The *NCS* majority has thus deprived target boards both of a negotiating strategy (precommitment) and an exchangeable commodity (certainty).

Certainty and commitment are not, of course, without potential costs. But, as an alternative to the bright line rule adopted by the *NCS* majority, this article has articulated a more flexible approach to controlling these costs by focusing precisely on the structural threat posed by a well-protected merger agreement. Merger and acquisition transactions place target directors in an unconstrained last period problem, loosening the norms that

<sup>&</sup>lt;sup>261</sup> *Id.* (Steele, dissenting).

ordinarily constrain their behavior and increasing the incentives favoring selfish behavior. Fortunately, this structural dilemma has a structural solution. A market check inserts constraints into this situation by reintroducing the market for corporate control. Because a competitive control market will prevent target boards and managers from behaving selfishly or foolishly, where a good faith market check has reinserted this constraining influence, a target board should be able to follow an affirmative precommitment strategy by agreeing to a particular deal and protecting its choice with strong deal protection provisions.

In short, the *NCS* rule is bad law, bad economics, and bad policy. In this, it recalls *Van Gorkom*, <sup>262</sup> another 3-2 decision arriving at a famously wrong conclusion that unleashed a flood of controversy and from which Delaware beat a hasty retreat. <sup>263</sup> By citing *Van Gorkom* in the first footnote of his dissent, Chief Justice Veasey may be hinting that we are in store for more of the same in the aftermath of *NCS*. <sup>264</sup> Indeed, corporate lawyers have already suggested that they may reincorporate their clients in other jurisdictions with more moderate approaches to deal protections and fiduciary outs, <sup>265</sup> effectively lobbying for a rule change with an implicit threat against one of the state's major sources of revenue. <sup>266</sup> As Delaware courts seek an exit strategy from the

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<sup>&</sup>lt;sup>262</sup> 488 A.2d 858 (Del. 1985).

<sup>&</sup>lt;sup>263</sup> See generally Symposium, Van Gorkom and the Corporate Board: Problem, Solution, or Placebo? 96 Nw. U. L. REV. 447 (2002) (cataloguing legal academy's continuing frustration with the Van Gorkom decision).

<sup>&</sup>lt;sup>264</sup> Omnicare, Inc. v. NCS Healthcare, Inc., 2003 Del. LEXIS 195, at \*73, n.90 (Del.S.Ct. Apr. 4, 2003) (Veasey, dissenting).

<sup>&</sup>lt;sup>265</sup> See, e.g., Meredith M Brown and William D Regner, Delaware to Directors: Don't Do Done Deals, Debevoise & Plimpton Client Memo, available online at <a href="http://www.debevoise.com/publications">http://www.debevoise.com/publications</a> ("Not every company is incorporated in Delaware. ...[I]t is possible that courts outside Delaware would be more likely to defer to the business judgment of an informed and disinterested board to grant a lock-up.").

<sup>&</sup>lt;sup>266</sup> See Kahan & Rock, supra note 74, at 906-907 (describing importance of corporate franchise fees in Delaware's state budget).

rule announced in *NCS*, the market check proposal described in this article may offer an effective, yet moderate alternative, consistent with the cautious fact-intensive nature of the Delaware corporate law.