How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware and the Strategic Use of Comity

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Abstract

The Bear Stearns/JP Morgan Chase merger placed Delaware between a rock and a hard place. On the one hand, the deal's unprecedented deal protection measures – especially the 39.5% share exchange agreement – were probably invalid under current Delaware doctrine because they rendered the Bear Stearns shareholders' approval rights entirely illusory. On the other hand, if a Delaware court were to enjoin a deal pushed by the Federal Reserve and the Treasury and arguably necessary to prevent a collapse of the international financial system, it would invite just the sort of federal intervention that would undermine Delaware's role as the de facto provider of U.S. corporate law.

Faced with a choice between undermining the delicate and subtle balance struck between managers and shareholders and standing in the way of the imperatives of national and international economic policy, Delaware found a third way that avoided both horns of the dilemma: it took advantage of a pending New York action to stay the Delaware action and avoid making any decision at all. In this article, we tell this story, analyzing the doctrinal issues under Delaware corporate and procedural law, and discussing the implications of this episode for our understanding of the landscape of US corporate law making.

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I. Introduction

Delaware is the state of incorporation of more than half of the publicly traded corporations in the United States. No other state even comes close.[1] Under the "internal affairs" rule, the law of the state of incorporation governs the internal affairs of the corporation – the rules of corporate decision-making, the allocation of power between shareholders, directors and management, and fiduciary duties[2] – and other states often look to Delaware law in fashioning their own rules.[3] Delaware, one of the smallest states in the nation, has thus become the de facto national lawmaker for corporate law.[4]

Yet, Delaware's dominant position in corporate law can feel fragile. Congress could legislate a national corporate law. The SEC encroaches from a variety of directions.[5] Other states could displace Delaware, just as Delaware displaced New Jersey nearly a hundred years ago.[6]

Delaware has so far been successful in fending off these potential threats. To be sure, our colleague Mark Roe has expounded the view that Delaware enjoys little autonomy in devising its corporate law because it must constantly respond to the threat of federal preemption.[7] We have argued that the relationship is far more complementary than Roe suggests.[8] But, regardless of whether Roe or we are right about Delaware's legal autonomy, it is clear that, from a business perspective, Delaware is a stunning success: Delaware earns more than $550 million per year in franchise taxes;[9] these fees amount to more than 20% of its annual tax revenues;[10] Delaware's market share of public corporations has increased from 30% for firms that went public between 1960 to 1964, to 56% for firms that went public between 1980 to 1984, to 77% for firms that went public between 1995 to 1998;[11] and no other state attracts more than a minimal

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[1] Robert Daines, *The Market for Corporate Law: Lawyers, Takeovers, and the Home-Court Advantage*, 77 *N.Y.U. L. Rev.* 1559 (2002); Lucian A. Bebchuck and Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 *J. L. & Econ.* 383 (2003); Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, 22 *Journal of Law, Economics and Organization* 340 (2006); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 *U. Pa. L. Rev.* 1795 (2002).

[2] William Meade Fletcher, *Fletcher Cylopedia of the Law of Corporations*, § 43.72 (2007).

[3] Mullen v. Academy Life Ins. Co., 705 F.2d 971, 973 n.3 (8th Cir. 1983) ("[C]ourts of other states commonly look to Delaware law ... for aid in fashioning rules of corporate law.").

[4] Marcel Kahan and Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 *Vand. L. Rev.* 1573 (2005) [hereinafter, *Symbiotic Federalism*].

[5] Mark Roe, *Delaware's Competition*, 117 *Harv. L. Rev.* 588 (2003).

[6] Marcel Kahan and Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 *Stan. L. Rev.* 679 (2002)

[7] Mark Roe, *Delaware's Competition*, 117 *Harv. L. Rev.* 588 (2003).

[8] Kahan & Rock, *Symbiotic Federalism*, supra n. XX. For another view, see Larry Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749 (2006).

[9] Financial Summary: Budget Dollar Governor's Recommended Budget: Fiscal Year 2008, http://budget.delaware.gov/fy2008/operating/08opfinsumcharts.pdf (in 2006).

[10] Id.

[11] Robert Daines, *The Market for Corporate Law: Lawyers, Takeovers, and the Home-Court Advantage*, 77 *N.Y.U. L. Rev.* 1559, 1572 (2002).

percentage of public corporations that are not headquartered in the state.[12] Up to now, at least, any federal encroachment on Delaware's autonomy may have hurt its pride, but not its pocket-book.

Yet it remains true that there is no assurance that the goose that lays Delaware's golden eggs will live forever. As we have argued elsewhere, the biggest threat facing Delaware is the emergence of some major crisis that focuses public attention on the peculiar mode of U.S. corporate law-making – where the elected officials and judges of one of the smallest states set the rules governing most publicly traded corporations – and undermines the public faith in Delaware's ability to handle the job.[13]

The recent events leading to the demise of Bear Stearns thus presented a problem for Delaware. The shareholder litigation challenging JP Morgan's acquisition of Bear Stearns caught Delaware between a rock and a hard place. How does Delaware respond when it finds itself with a choice between picking a fight it cannot win and maintaining the integrity of the fabric of Delaware corporate law?

Delaware came up with a wonderful answer: let New York decide! As we describe in this essay, Delaware, when faced with a set of deal protection measures that raised serious problems under Delaware law, managed what one might have thought impossible – it avoided a fight and also avoided undermining Delaware's nuanced jurisprudence – by the simple expedient of deferring to a court of a sister state (never mind that it was not the state of incorporation!).

Part II of this article briefly describes the final days of Bear Sterns and the two deals it struck with JP Morgan. Part III provides a legal analysis of the deal protection measures in the Bear Stearns-JP Morgan merger agreement, with particular attention to the Share Exchange Agreement, and explains why the Share Exchange Agreement is likely invalid under current Delaware doctrine. Part IV discusses the dilemma Delaware faced when asked to adjudicate a transactions that, on the one hand, was arguably needed to prevent the collapse of the financial system but that, on the other hand, was hard to reconcile with existing Delaware law. Delaware escaped this dilemma by staying the Delaware action in favor of a contemporaneous action filed in the New York state court. Delaware's decision to stay does not accord with Delaware's usual practice in resolving stay motions in significant corporate law cases and can best be understood as a strategic decision to abstain from adjudicating a case that potentially threatened Delaware's place in the corporate law-making landscape. Part V examines the implications for corporate federalism.

II. Background

The spectacular failure of Bear Stearns was front page news. Now that the dust has settled, the outlines of what happened are reasonably clear, although there is much

[12] Robert Daines, *The Market for Corporate Law*, supra n. XX.
[13] Kahan & Rock, *Symbiotic Federalism*, supra n. XX.

that remains mysterious. What follows is a sketch of the chain of events that led to JP Morgan's (JPM) acquisition of Bear Stearns (BSC).[14]

During the week of March 10, rumors began to circulate on Wall Street that BSC was in trouble, and customers began leaving in droves.[15] By the end of the day of Thursday, March 13, it was clear that BSC faced a crisis. So many customers had pulled out their assets that BSC had exhausted $15 billion in cash reserves.[16] Lenders who financed BSC's operations refused to replenish the financing.[17] Clients of other banks were pushing to get out of trades with BSC. By the evening of March 13, BSC was considering all options: it turned to JPM to see if it would buy BSC; it considered bankruptcy; representatives of the Federal Reserve were camped out in BSC's offices.[18]

By early morning on Friday, March 14, time had run out. The Federal Reserve and the Treasury were concerned that a BSC collapse would have far reaching effects. A Fed official is quoted as saying "For the first time in history the entire world was looking at the failure of a major financial institution that could lead to a run on the entire world financial system. It was clear we couldn't let that happen."[19] To prevent this from happening, JPM, with non-recourse financing from the Federal Reserve, agreed to provide financing to BSC for "up to 28 days."[20]

With the JPM and Fed commitments, BSC was able to open for business on Friday, but customers continued to flee and trading partners to disappear. Throughout the day, BSC's stock price continued to drop, closing at $32 per share.[21] Teams from JPM, private equity firms J.C. Flowers and KKR, and major banks poured over BSC.[22] Friday evening, Treasury Secretary Henry Paulson and NY Fed chief Timothy Geithner made it clear that a deal to sell BSC had to be announced by early Sunday evening when the Asian markets opened.[23] The "28 day" window had suddenly closed.

By the end of the day Saturday, March 15, Flowers made a conditional offer of $28 per share in cash, contingent on lining up financing to continue BSC's operations. Later, JPM indicated that it might be willing to buy BSC for $8 to $12 per shares.[24]

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[14] The account is based on: Kate Kelly, Lost Opportunities Haunt Final Days of Bear Stearns: Executives Bickered Over Raising Cash, Cutting Mortgages, WSJ May 27, 2008; Page A1 (WSJ1); Kate Kelly, Fear, Rumors Touched Off Fatal Run on Bear Stearns, WSJ May 28, 2008; Page A1(WSJ2); Kate Kelly, Bear Stearns Neared Collapse Twice in Frenzied Last Days, May 29, 2008; Page A1 (WSJ3); and Bryan Burrough, The Collapse: Bringing Down Bear Stearns, Vanity Fair (August 2008) (VF).
[15] WSJ2. VF.
[16] WSJ2.
[17] Id.
[18] WSJ2.
[19] VF.
[20] WSJ2.
[21] WSJ3.
[22] WSJ3; VF.
[23] WSJ3; VF.
[24] WSJ3.

Sunday morning, JPM presented a draft merger agreement with the price left blank.[25] It became clear that Flowers would not be able to go forward. At about 10 am, JPM withdrew its offer, but soon returned with a $4 per share price, with the Fed taking responsibility for $30 billion of illiquid securities. BSC managers, irate with the low $4 per share price, seriously contemplated a bankruptcy filing.[26] Paulson spoke with JPM CEO Dimon and pushed for a price even lower than $4 per share.[27] The Secretary of the Treasury had his own political motivations for pushing for a low price. He wanted to avoid the impression that the government was bailing out the shareholders of an investment bank that had speculated, while offering no help to the little guy who had defaulted on his sub-prime mortgage.[28]

By mid-afternoon Sunday, March 16, JPM made a firm offer at $2 per share. Faced with a choice of bankruptcy or $2 per share, the BSC board accepted.[29]

The March 16 merger agreement contained a variety of fairly standard "deal protection" measures. JPM got an option to buy BSC's corporate headquarters building for $1.1 billion (the "Asset Option"), and an option to buy 19.9% of Bear Stearns stock at $2 per share. The BSC board also provided the necessary approvals to waive the limitations on business combinations under §203 of the Delaware General Corporation Law ("DGCL"). But, as in the case for most mergers, §251 of the DGCL required approval of a majority of Bear Stearns' outstanding shares for the BSC/JPM merger.

During the week of March 17, it became clear that BSC shareholder approval could not be assumed. A variety of shareholders, including some of the largest ones, had seen the value of their BSC shares fall from a high of $131.58 in October, 2007,[30] to $70 per share in early March and now voiced opposition to the proposed merger at $2 per share. Many took the position that if that was all they would get, they might as well take their chances. Approval of the merger on the original terms seemed far from certain. At the same time, customers continued to pull out assets, thus reducing the value of the company as a stand-alone entity or as an acquisition target.

In response to shareholder opposition, BSC and JPM revisited the original $2 deal. JPM demanded that BSC allow it to hold 51% of BSC shares as part of any renegotiated deal, to assure shareholder approval. BSC argued that it would need to get a higher price. Over the weekend of March 22-23, intense negotiations continued. Concerned again that a BSC bankruptcy could imperil the financial system, Paulson reluctantly acquiesced in a higher price.[31] Early Monday morning, March 24, a revised deal was announced.[32] Under the "Amended Merger Agreement" and the related "Share Exchange Agreement" (SEA), the merger consideration was increased to about $10 per

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[25] WSJ3.
[26] WSJ3.
[27] Id.
[28] WSJ3
[29] Id.
[30] WSJ2.
[31] WSJ3.
[32] WSJ3.

share, the JPM and Fed Reserve guarantees were limited, the Section 203 waiver was retained, the Asset Option was retained, and, most importantly for our purposes, an additional deal protection measure was included: the share exchange. Under the SEA, JPM would receive, through an exchange of JPM shares, 95 million newly issued shares of Bear Stearns common stock (amounting to 39.5% of the then outstanding shares), with the share exchange completed before the April 8, 2008 record date for the Bear Stearns shareholder vote on Amended Merger Agreement. The admitted purpose of the SEA was to provide assurance to JPM that the transaction would receive the requisite approval of Bear Stearns' shareholders.[33]

Neither the Amended Merger Agreement nor the SEA limited JPM's ability to acquire additional shares. With no limits placed on market purchases, JPM bought an additional 11.5 million shares at $12.23 per share (about 8%) on March 24, the date the SEA was announced, and another 10 million shares or so before April 18,[34] in order to, according to JPM's own securities filings "increase the likelihood that the plan to rescue Bear Stearns will be completed."[35] By the time of the BSC shareholder vote, JPM controlled around 49.73% of all outstanding share. And it had acquired this stake without any approval of the other BSC shareholders.

The frenzied negotiations were, of course, accompanied by the filing of lawsuits. On March 17 and 18, the two days after the $2 per share merger agreement was announced, stockholder class actions were filed in New York Supreme Court. On Thursday, March 20, and Monday, March 24 (the day the Amended Merger Agreement and SEA were announced), stockholder class actions were filed in Delaware Chancery Court. On March 27, defendants move to dismiss or stay the Delaware action in favor of the New York action. On April 9, the Delaware Chancery Court granted the motion to stay. It thus looked that it would be the New York, rather than the Delaware court, that would decide the issues raised by the case and specifically, the important question of whether the Bear Stearns board acted appropriately in signing the Share Exchange Agreement.

The end of this story, alas, is anti-climatic. With no other bid forthcoming and shareholder opposition waning, the plaintiffs in the NY action withdrew their motion to enjoin the merger on May 7.[36] On May 29, the merger was approved by 84% of the BSC shares.[37]

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[33] JPM, Schedule 13D, April 3, 2008 ("JPMorgan Chase acquired the shares of Common Stock in order to increase the likelihood that the plan to rescue Bear Stearns will be completed.")

[34] JPM March 24, 2008 13d. JPM , Schedule 13D, 5th am. April 19, 2008

[35] Id.

[36] JP Morgan Chase May 8 Form 8K..

[37] Kate Kelly, Mike Spector and Randall Smith, The Fall of Bear Stearns: Bear's Final Moment: An Apology And No Lack of Ire, The Wall Street Journal, May 30, 2008 Friday, Pg. C1.

III. The Issues Under Delaware Law

The SEA, under which JPM acquired 39.5% of the BSC shares in advance of the shareholder vote, was an unprecedented "deal protection" measure, and raised difficult and important issues under Delaware law.[38] As we will argue in this Part, based on *existing* statutory and case law, the SEA should have been enjoined. This, of course, does not mean that we believe that a Delaware court would have actually invalidated the SEA. To the contrary, as we discuss below, we think that the SEA would have been upheld, whether heard by a Delaware court or by a New York court. It is this combination – the practical necessity of upholding the SEA versus its dubious legality under current Delaware law – that puts the SEA into the "Hard Cases Make Bad Law" category and placed Delaware in a peculiar dilemma.

Mergers, under §251 of the Delaware General Corporation Law, require both a recommendation of the board of directors and approval by a majority of the outstanding shares.[39] This two stage process is a center-piece of the Delaware corporate governance system, with both elements considered critical. The Delaware Supreme Court has held that the board cannot submit a merger agreement to the shareholders without making a recommendation, and the board's duty to take a position on a merger is one of the hooks on which the structure of fiduciary duties is hung.[40] Equally, the shareholders' right under Del. GCL §251(a) to vote down a merger approved by the board forms the foundation of the courts' scrutiny of defensive tactics, including deal protection measures.[41] Although issues arise in a variety of contexts, the fundamental principle governing these issues is that shareholders' vote must be uncoerced.

Vice Chancellor Strine, in a recent law review article, argued that a focus on "uncoerced stockholder choice" provided the best guide and balance of the competing interest.[42] Although, says Strine, this standard provides substantial discretion to directors, it also sets clear limits:

> At the same time, this emphasis on stockholder choice recognizes that a stock-for-stock merger agreement is not an ordinary contract within the sole power of the directors to consummate. Stockholders have the right to vote yes or no without being, in essence, compelled or coerced. Stockholders can legitimately expect that their directors will bring a merger proposal to a reasonably prompt vote so that the mere passage of time does not leave the board's preferred deal as the only viable

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[38] Although, under NYSE rules, shareholder approval is ordinarily required for issuance of more than 20% of the outstanding shares, NYSE Listed Company Manual ¶312.03, an exception can be granted by the Exchange "when (1) the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise and (2) reliance by the company on this exception is expressly approved by the Audit Committee of the Board." NYSE Listed Company Manual ¶312.05. In entering into the SEA, BSC relied upon this exception and, on April 4, received approval from the NYSE. www.reuters.com/article/pressRelease/idUS208849+04-Apr-2008+BW20080404

[39] Del. GCL §251.

[40] Smith v. Van Gorkom, 488 A.2d 858, 879 (1985); see also A. Gilchrist Sparks, Merger Agreements Under Delaware Law - When Can Directors Change Their Minds?, 51 U. Miami L. Rev. 815, 819 (1997).

[41] See, e.g., Paramount v. QVC, 637 A.2d 34, 42-43 (Del. 1994).

[42] Categorical Confusion at TAN 73.

corporate strategy. Stockholders also have a right to a genuine, current recommendation from their directors regarding the advisability of the transaction.[43]

The fundamental problem with the SEA is that it eliminates the effective "right to vote yes or no without being . . . compelled or coerced."[44] In doing so, it makes a mockery of the approval requirement under §251.

In this Part, we first discuss three separate doctrinal frameworks in Delaware law through which a Delaware court would likely analyze the Share Exchange Agreement: the *Unocal/Unitrin* framework, the *Omnicare* framework; and the *Blasius* framework.[45] We then discuss some arguments, based on existing precedent, for upholding the agreement. We conclude that, under existing doctrine, the case for upholding the SEA was weak. This placed a Delaware court in a very difficult situation. If a Delaware judge had to make a decision, he or she could have done one of the following: invalidate the agreement, with the risks that entailed; fashion a new rule of Delaware law which Delaware would then have to spend years explaining and limiting; or pretend, with the attention of the world focused on it, that the facts of the case or the law of Delaware were different from what they were, and thus expose itself to ridicule.

A. The *Unocal/Unitrin* Analysis

The *Unocal*[46] and *Unitrin*[47] cases provide the basic framework within which Delaware courts review defensive actions by a board of directors. As the earlier description makes clear, the SEA was adopted in order to ensure that the preferred deal with JPM was approved and that no competing bid emerged. As such, it is a classic defensive measure subject to the two part *Unocal/Unitrin* test. The first prong requires that the board reasonably perceive that there is a threat to

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[43] Id. at TAN 73.
[44] Id.
[45] The SEA also raised issues under *Revlon*. Whether or not the BSC/JPM merger was approved, the SEA agreement, especially in light of BSC's freedom to acquire additional shares, created a controlling shareholder where there was not one before. As such, under *Paramount v. QVC*, the SEA triggers *Revlon*. It is not, however, clear that an analysis under *Revlon* adds anything to the analyses under *Unocal/Unitrin*, *Omnicare* and *Blasius*. It could be important in two different ways. First, when a board is in "Revlon mode," only shareholder interests count: "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 further that end. The decisions of this Court have consistently emphasized this goal." QVC at 44. Second, *Revlon* requires some sort of market test: either an auction before an agreement is reached or at least the possibility of a competing bid after. Cite. Because of time pressures, only the briefest of auctions was conducted before the merger agreement was signed. The SEA, combined with JPM's post-March 24 stock purchases, gave JPM a 49.7% position and, in so doing, precluded any sort of post-agreement market test. Whether, in this circumstance, the board could, consistent with *Revlon*, agree to a deal that did not leave the shareholders with the opportunity to accept a competing bid is an issue fully discussed in the context of *Omnicare*, infra.
[46] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985).
[47] *Unitrin v. American General Corp.*, 651 A.2d 1361, 1367 (Del. 1995).

the corporation. The second prong requires that any defense be reasonable in relation to the threat.[48]

It is the second prong of *Unocal* that is of particular interest here. *Unitrin* established a bi-furcated analysis for deciding whether a defense is reasonable.[49] First, the court must decide whether a defense is coercive or preclusive. If it is, it is invalid. If it is not, the court then turns to whether the defense falls within a "range of reasonableness," a relatively permissive standard.[50] *Unitrin* provided definitions of both key concepts: "a response is 'coercive' if it is aimed at forcing upon stockholders a management-sponsored alternative to a hostile offer;"[51] "a response is 'preclusive' if it deprives stockholders of the right to receive all tender offers or precludes a bidder from seeking control by fundamentally restricting proxy contests or otherwise."[52]

Applying *Unitrin*'s definitions directly, it is difficult to imagine an action by a board that could be more coercive and preclusive than the SEA. With the SEA, JPM instantly acquired a 39.5% voting block, almost 80% of the votes needed to approve the merger. But the SEA does not stop there: it does not contain any standstill agreement or other limitation on JPM's market purchases, any duty by JPM to support a higher offer, or any right of the board not to submit the merger to a shareholder vote if no longer recommends the merger.[53] In fact, JPM, unconstrained by any such restrictions, immediately began acquiring additional shares so that it had just shy of 50% of the shares in advance of the meeting to vote on the merger.[54] JPM, of course, could have easily acquired a little more, giving it all the shares needed to approve the merger without the vote of a single other shareholder, but what was the point of doing so?

Under these circumstances, two things were clear: shareholders could not vote the deal down and remain independent; and no other bidder would have any chance of succeeding with a higher offer. The SEA was thus coercive because it literally forced the BSC/JPM merger on shareholders. Even if an overwhelming majority of the non-JPM shareholders would have opposed the merger, the merger would have received the requisite shareholder votes. The SEA was preclusive because it deprived shareholders of the right to receive any other offers, and precluded any other bidder from seeking control, by the most fundamental restriction of a proxy contest possible, namely, giving the board's preferred merger partner a controlling interest.

Notably, the SEA was entered into by the board of directors of Bear Stearns without any shareholder approval and, as far as we know, without even consulting

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[48] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985).
[49] *Unitrin v. American General Corp.*, 651 A.2d 1361, 1367 (Del. 1995).
[50] Omnicare at fn. 50 (citing Unitrin).
[51] *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995).
[52] Id.
[53] Amended Merger Agreement and SEA
[54] The Bear Stearns Companies Inc., Schedule 13d (Rule 13d-101) (Apr. 3, 2008).

any of the larger BSC shareholder who were not on the BSC board. In fact, the SEA and the Amended Merger Agreement were motivated by shareholder opposition to the initial deal struck by the board of directors.[55] With shareholders up in arms and threatening to oppose the initial merger, the board, on its own, gave up the effective right of shareholders to vote down the JPM deal in exchange for an increase in the merger consideration. To be sure, the increase (relative to the original $2 deal) was pretty substantial. But the obvious point of the dual approval requirement embodied in Section 251 of the DGCL is not that the board can dispense with a shareholder vote if a deal is good enough, but that it is the prerogative of shareholders to decide, in an uncoerced fashion, *whether* a deal is good enough. Undermining this principle would have important ramifications for Delaware law.

Indeed, there is a large Delaware jurisprudence on the permissible scope of deal protection measures under *Unocal/Unitrin.* The issue typically arises in contexts very similar to the BSC/JPM situation: a target board and an acquirer, which have negotiated a merger agreement, are concerned that shareholders will not approve it. To address this possibility, the merger agreement includes a variety of measures, such as an agreement to sell a valuable asset for a low price (an "asset lockup"), an agreement to sell a block of shares for either a low price or the deal price (a "stock lockup") and an agreement to pay the merger party a sum of money (a "termination fee"), each contingent on the deal not being approved.[56]

The traditional deal protection measures discussed in Delaware cases are significantly less coercive and preclusive than the provisions at issue in Bear Stearns. Typical provisions such as asset and stock lock-ups and termination fees are primarily designed to confer an *economic* benefit on the favored bidder if another bidder should acquire the target at a higher price (or, to a lesser extent, if shareholders independently fail to approve the deal). Their direct effect is thus to offer a consolation prize to the favored bidder should the deal fall through, as compensation and inducement for the effort to make a bid to start with. Despite their name, these provisions do not confer nearly enough (and often no) voting power on the favored bidder to *lock up* a deal in the literal sense. Any lockup effect of these traditional measures is generated by the size of the economic benefit conferred on the friendly acquirer. Since this benefit comes out of the pocket of target shareholders (and, if there is hostile interference, of the hostile bidder), any alternative to the negotiated merger must be sufficiently valuable to the target shareholders to make it economically desirable for them to reject the merger. This, of course, depends on the value of the negotiated merger to target shareholders, the size of the economic benefit conferred by the deal protection devices, and the value of any alternative – values that will differ from case to case.[57] Some commentators believe that

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[55] WSJ3.

[56] These deal protection devices also have the effect of discouraging competing bids, if large enough. We do not address this aspect directly as there was no competing offer for BSC, and no evidence that an competing offer was scared away by the deal protection measures.

[57] Ian Ayres, *Analyzing Stock Lock-Ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 *Colum. L. Rev.* 682, 704 (1990); Marcel Kahan and Michael Klausner, *Lockups and the Market for Corporate Control*, 48 *Stan. L. Rev.* 1539 (1996).

these traditional devices rarely affect the outcome of a bidding contest.[58] Still, at least in theory, these traditional sorts of deal protection measures can rise to a magnitude at which they economically coerce shareholders into approving a merger.

Vice Chancellor Strine, in his law review article, provided the following intentionally extreme example of an unacceptable measure:

> "If our hypothetical merger agreement, for example, provided that Angstrom would receive a 50% termination fee if the Zuckerman stockholders voted no, very few of us would think that was permissible. By making the costs of voting no so extreme, the Zuckerman board has in effect usurped all of the power to approve the merger to itself, in derogation of the statutory allocation of powers. Put simply, the Zuckerman board cannot contract away its stockholders' right to make an uncoerced decision."[59]

Delaware courts have enjoined traditional deal protection measures which interfere with shareholders' decision. Thus, for example, in *Paramount v. QVC*,[60] the Delaware Supreme Court addressed a combination of a $100 million termination fee and an uncapped option to purchase 19.9 percent of the stock at the deal price with unusually favorable payment terms (payable with a note, with a right to settle in cash). Both the termination fee and the stock option would have been triggered by a negative shareholder vote. The Court held that the stock option contained several "draconian" features and was clearly invalid.[61] In other cases, Delaware courts have approved termination fees in the range of 2-4% of deal value,[62] have expressed skepticism about a fee over 6%,[63] and have made it clear that there are no hard and fast rules.[64]

The SEA is substantially more draconian than these deal protection devices. From a purely economic perspective, the 39.5% SEA offers an even greater opportunity of uncapped profits should there be a bidding war for Bear Stearns, than the 19.9% stock option that was held invalid in *QVC*.[65] But, more importantly, the SEA, whether

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[58] See Ayres, supra n. XX (arguing that only "foreclosing" lockups affect the outcome of a contest). Fraiden and Hanson, XXX.

[59] Strine, Categorical Confusion at n. 39.

[60] *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994).

[61] QVC at 55.

[62] McMillan v Intercargo, 768 A.2d 492 (Del. Ch. 2000) (3.5%); Brazen (2%); *Kysor*, 674 A.2d at 897 (2.8%); *Roberts v. General Instrument Corp.*, 1990 Del. Ch. LEXIS 138, Del. Ch., C.A. No. 11639, slip op. at 21, Allen, C. (Aug. 13, 1990) (2%); *Lewis v. Leaseway Transp. Corp.*, 1990 Del. Ch. LEXIS 69, Del. Ch., C.A. No. 8720, slip op. at 6, Chandler, V.C. (May 16, 1990) (3%); *Braunschweiger v. American Home Shield Corp.*, 1989 Del. Ch. LEXIS 142, Del. Ch., C.A. No. 10755, slip op. at 19-20, Allen, C. (Oct. 26, 1989) (2.3%); In re Pennaco Energy, Inc. Shareholders Litigation, 787 A.2d 691 (Del. Ch. 2001))(3%).

[63] Phelps Dodge v. Cyrus Amax, 1999 Del. Ch. LEXIS 202.

[64] Louisiana Mun. Police Employees' Retirement System v. Crawford, 918 A.2d 1172, 1181 n. 10 (Del. Ch. 2007).

[65] The distinction between the actual acquisition of stock envisioned by the SEA and a mere option in *QVC* is not economically meaningful in the context of these transactions. To be sure, the fact that Viacom only received an option means that it would have no incentive to exercise the option if the value of Paramount dropped below the deal price. But Viacom also had a contractual obligation to consummate the merger at the deal price. If the value of Paramount dropped, it was Viacom's contractual obligation under the merger

considered by itself, or in the context of JPM's permitted additional stock purchases, conferred upon JPM sufficient voting power to make it virtually impossible for BSC shareholders to vote down the Amended Merger Agreement.

From this perspective, the facts of *Unitrin* are illustrative.[66] In *Unitrin*, the board of Unitrin, when faced with a hostile offer, engaged in a share repurchase that increased the stake held by board members (who had agreed not to sell their shares) from 23% to 28%.[67] The Chancery court invalidated the share repurchase program under *Unocal*.[68] The Supreme Court reversed, finding that the program was neither coercive nor preclusive. But in doing so, it engaged in a probing analysis of Unitrin's shareholder base. It found, first, that there was no reason to believe that all board members, which included some large, outside shareholders, would automatically oppose any bid. Moreover, even if all board members opposed the bid, the court found that the increase in the board stake from 23% to 28%, given the percentage of shares held by institutional investors, would not present a barrier that a hostile bidder could not realistically overcome.[69]

The contrast between the facts in *Unitrin* and those in Bear Stearns are stark. Unlike the outside board members of Unitrin, JPM could surely be expected to oppose any competing bid and to vote in favor of the merger even if, at the time of the vote, the merger looked like a bad deal for BSC. The SEA represented an *increase* in ownership that, on its own, was *eight* times higher than the increase at issue in *Unitrin* – from 0% to 39.5% versus 23% to 28%. Adding to the SEA shares the 11.5 million shares that JPM acquired contemporaneous with the announcement of the SEA brought JPM's stake to 45%; with the further shares acquired over the next few weeks, JPM's ownership increased to 49.73%.[70] Any notion that the deal was not locked up by March 24 – because JPM's ownership was below 50% and there was a hypothetical possibility that shareholder approval would not be obtained – flies in the face of both reality as well as the careful, contextual analysis performed by the Delaware Supreme Court in *Unitrin*.

We thus believe that, under *Unocal/Unitrin*, the SEA would be regarded as a coercive and preclusive defensive device and held invalid. This, of course, would be sufficient to doom the SEA. But even if the SEA somehow survived *Unocal/Unitrin* scrutiny, it would face further hurdles.

B. The *Omnicare* Analysis

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agreement that is important, and not Viacom's rights under the deal protection measures. But if Viacom consummates the merger, it does not matter whether it first exercises the option or not. Because Viacom has an obligation to consummate the merger under the merger agreement, the fact that Viacom received an option rather than shares conferred no downside risk protection on Viacom.

[66] *Unitrin v. American General Corp.*, 651 A.2d 1361 (Del. 1995).

[67] Id. at 1377-78.

[68] Id. at 1375-77..

[69] Id. at 1381-83.

[70] The Bear Stearns Companies Inc., Schedule 13d (Rule 13d-101) (Apr. 3, 2008)..

The 2003 Delaware Supreme Court opinion in *Omnicare v. NCS* arose out of the specific context of voting agreements and has particular application to the SEA.[71] At issue in *Omnicare* were agreements by the controlling shareholders to vote in favor of a proposed merger and an agreement by the board of the company to submit the merger to a shareholder vote even if it no longer believed, at the time of the vote, that the merger was in the company's best interest. The Delaware Supreme Court held that these agreements were coercive and preclusive because they rendered the merger a *fait accompli*:

> The record reflects that the defensive devices employed by the NCS board are preclusive and coercive in the sense that they accomplished *a fait accompli*. In this case, despite the fact that the NCS board has withdrawn its recommendation for the Genesis transaction and recommended its rejection by the stockholders, the deal protection devices approved by the NCS board operated in concert to have a preclusive and coercive effect.[72]

Omnicare is a problematic and widely criticized opinion.[73] The voting agreements in that case were executed by the company's *shareholders*, not by the board of directors. The agreements thus do not raise the concern underlying *Unocal* that the board of directors is acting in its own interest in adopting a defensive device or the concern that *the board* is usurping shareholder's effective right to vote on a merger.[74] To be sure, the board of directors in *Omnicare* made a firm agreement to submit the merger to a shareholder vote.[75] Such agreements, however, are specifically permitted by the DGCL[76] and the court did not find any flaws in the process that the board engaged in before it signed the agreement. Rather, the decision was based on the principle that there must always be an effective "out," and if the shareholder vote is not an effective out (because of voting agreements signed by the shareholders) then the board cannot give up the right to withdraw its recommendation and pull the proposed deal from a shareholder vote.[77]

Under the reasoning of *Omnicare*, the SEA would be invalid. As in *Omnicare*, the BSC board agreed to submit the merger to a shareholder vote even if it no longer believed, at the time of the vote, that the merger was in the company's best interest. The SEA, in effect, accomplishes a fait accompli. Even standing by itself, the 39.5% stake transferred in the SEA would make it exceedingly difficult to defeat the deal on the shareholder level. But coupled with JPM's contemporaneous acquisition of another 5%

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[71] *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).
[72] Omnicare at **61.
[73] See, e.g., Robert A. Profusek & Lyle G. Ganske, Lockups and Beyond in 'Omnicare v. NCS Healthcare', 229 N.Y.L.J. 4 (2003); Wayne O. Hanewicz, *Director Primacy, Omnicare, and the Function of Corporate Law*, 71 *Tenn. L. Rev.* 511, 514 (2004); other cites.
[74] To be sure, the non-controlling shareholders lacked an effective right to defeat the merger. This, however, was true regardless of the voting agreement. What the voting agreement did was to eliminate the effective right of the controlling shareholders to defeat the merger. Since the controlling shareholders agreed to the Voting Agreement, there is nothing problematic about this.
[75] The board of Bear Stearns made a similar commitment. See Section 2.6, Amendment No. 1 to Agreement and Plan of Merger, Bear Stearns Companies Form 8-K, March 24, 2008.
[76] DGCL §251(b)(6).
[77] *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 936-37 (Del. 2003). .

of BSC's stock, and its further acquisition of another 5% over the following weeks, this extreme difficulty became an impossibility. Given the timing of these acquisitions and the lack of any contractual restrictions on JPM's right to purchase additional shares, it is evident that JPM both intended to buy additional shares and that BSC should have expected JPM to buy additional shares when it agreed to the SEA. A court would thus be hard put to ignore these purchases in analyzing the SEA.

Moreover, the SEA is substantially more problematic than the agreements at issue in *Omnicare*. In *Omnicare*, the existing controlling shareholders, acting in good faith and ensuring that non-controlling shareholders would receive equal consideration, committed to vote in favor of the merger. By contrast, the SEA was a issuance of *new* shares *by board action*, which when combined with JPM's market purchases created a new controlling shareholder and was designed to take the decision entirely out of the hands of shareholders.

C. The *Blasius* Analysis

A line of Delaware cases, beginning with *Schnell v. Chris Craft*, continuing through *Blasius*, and reaffirmed in *Stroud v. Grace* and *Liquid Audio*, consistently protects the stockholder franchise against board attempts to interfere.[78] As the Delaware Supreme Court stated, when "boards of directors deliberately employ[] . . . legal strategies either to frustrate or completely disenfranchise a shareholder vote . . . there can be no dispute that such conduct violates Delaware law."[79] Such intentional interference, under *Blasius* and its progeny, is illegal, *even if the board acted in good faith*, unless it has a "compelling" justification. This raises the question of whether *Blasius* applies to the SEA and, if it does, whether the BSC board had a compelling justification needed to survive *Blasius.*

As we discuss in this Section, the argument that SEA is invalid under *Blasius* is not fully resolved (whereas its invalidity under the current doctrines in the *Unocal/Unitrin* line of case or in *Omnicare* is, in our view, straightforward). This means, on one hand, that the Delaware courts would not have to engage in doctrinal contortions to reject a *Blasius* claim. On the other hand, however, it also means that the issue of the SEA's validity under *Blasius* raises important and novel questions under Delaware law.

As a threshold inquiry, one would have to resolve whether *Blasius* applies to the SEA. It is clear that the SEA both did, and was intended to, render the stockholder vote on the merger an empty formality, and thus fits squarely into the set of actions that constitute intentional interference with shareholders' franchise. What is less clear, however, is whether and how *Blasius* applies to shareholder

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[78] *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971); *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988); Stroud v. Grace, 606 A.2d 75, 91 (Del. 1992); *MM Companies, Inc. v. Liquid Audio, Inc.*,. 813 A.2d 1118 (Del. 2003).

[79] Stroud v. Grace, 606 A.2d 75, 91 (Del. 1992), cited and quoted with approval in Unitrin v. American General, 651 A.2d 1361, 1379 (Del 1995).

votes other than elections for directors. Dicta in *Blasius* suggested that the standard applied to interference with any shareholder votes.[80] But cases decided subsequently have arrived at somewhat different conclusions. Thus, in *Mercier v. Inter-Tel*, Vice-Chancellor Strine, as one alternative basis for the holding that a postponement of a merger vote was valid, held that *Blasius* never applied to merger votes.[81] In another Chancery Court opinion involving a merger vote, Vice Chancellor Lamb held that *Blasius* applied only when self-interested or faithless fiduciaries act to deprive stockholders of a full and fair opportunity to participate in the matter and to thwart what appears to be the will of a majority of he stockholders.[82] The court proceeded to uphold a board decision to change the record date for the merger since a change in the record date did not deprive stockholders of a full and fair opportunity to participate in the merger vote.

The upshot is that there is an unresolved conflict in the Chancery Court as to when *Blasius* applies in the merger context. Former Chancellor Allen presumably believes always, Vice-Chancellor Strine believes never, and Vice-Chancellor Lamb believes sometimes. Moreover, it is unclear whether, under Vice-Chancellor Lamb's test, *Blasius* would apply to the SEA. Unlike a postponement of the record date upheld by Lamb, the SEA clearly deprived the other BSC shareholders of a full and fair opportunity to participate in the merger vote. More problematic is whether the SEA was executed by self-interested or faithless fiduciaries. While the BSC board seems to have had no conflict of interest, a board action that both intentionally interferes with the shareholder franchise and deprives stockholders of a full and fair opportunity to participate in the merger vote may, by itself, render the board faithless under Lamb's test. After all, the whole point of *Blasius* was that a board cannot, *even in good faith*, intentionally interfere with shareholder franchise.

Assuming *Blasius* does apply, there is little Delaware law on what circumstances could establish a compelling justification under *Blasius*. In *Blasius* itself, none was shown. In dicta, Chancellor Allen suggested that the standard could possibly be met in a situation in which interfering with the shareholders' franchise was necessary to protect the shareholders from coercion.[83] Similarly, in the later Supreme Court case of *MM v. Liquid Audio*,[84] no compelling justification was shown and the issue of what may constitute a compelling justification was not

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[80] See, e.g., Blasius at 659-60 ("That is, a decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and the agent, has authority with respect to a matter of internal corporate governance. That, of course, is true in a very specific way in this case which deals with the question who should constitute the board of directors of the corporation, but it will be true in every instance in which an incumbent board seeks to thwart a shareholder majority.")

[81] See, e.g., Mercier v. Inter-Tel, 929 A.2d at 808-09 (Blasius does not apply to a merger vote; in the alternative, Blasius's compelling interest test is satisfied).

[82] CITE

[83] There seem to be only two cases in which a compelling justification was found, and in each case, only in the alternative. Hollinger Int'l v. Black, 844 A.2d 1022, 1089 (Del. Ch. 2004), cited in Inter-Tel at n. 71; and Inter-Tel itself.

[84] 813 A.2d 1118 (Del. 20003).

discussed.[85] But even though there is little case law on what constitutes a compelling justification under *Blasius*, it is clear it is meant to be a strict standard. As *Blasius* itself holds, a good faith belief by directors to be acting in the best interest of the corporation is not enough. And as a later Supreme Court case explain, the *Blasius* standard is very hard to meet.[86]

What "compelling justifications" plausibly existed here for a device that effectively precluded shareholders from exercising their governance rights? One might argue that the magnitude of the increase in the price from the original to the amended merger – from $2 per share to $10 per share – is so large as to create a compelling justification. But this is a difficult claim to sustain because the increase is only large relative to the $2 price, not the recent market price or the trading price of the shares over the preceding year. The fact that JPM was so keen to lock up the deal at $10 per share, and had in fact paid up to $12.23 per share for additional shares in the market, likewise indicates that the price was not compellingly rich.

What about the pressing need to close the deal to avoid a potential collapse of the financial system? The discussion in *Blasius*, including Chancellor Allen's hypothetical, all suggested that compelling interests need to be compelling *shareholder* or *corporate* interests. To be sure, the *Blasius* compelling justification standard, undefined as it is, could include pressing national interests. Whether it does, of course, represents another novel issue of Delaware law. This being said, the notion that the board of directors is permitted, in the exercise of its fiduciary duties, to take into account not just the interest of the company's shareholders, creditors, and other constituents, but the interests of parties who have no relationship whatsoever to the corporation is completely alien to Delaware law.

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[85] Similarly, in an earlier case discussed in *Blasius*, Chancellor Allen had enjoined a board issuance of stock in an attempt to dilute the voting power of a controlling shareholder, holding that no justification for such an extraordinary step had been shown. . See *Phillips v. Insituform of North America, Inc.*, Del.Ch., 1987 Del. Ch. LEXIS 474, C.A. No. 9173, Allen, C. (Aug. 27, 1987).

[86] *See Williams v. Geier*, 671 A.2d 1368, 1376 (Del.1996) (" *Blasius* ' burden of demonstrating a 'compelling justification' is quite onerous, and is therefore applied rarely."). The very stringency of the *Blasius* standard has limited its application, and has led courts to work hard to avoid characterizing actions as "disenfranchisement." Mercier v. Inter-Tel, 929 A.2d 786 (Del. Ch. 2007), citing Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1122-23 (Del. Ch. 1990); Chesapeake Corp. v. Shore, 771 A.2d 293, 322-23 & n. 58 (Del. Ch. 2000); William T. Allen, et al,., Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 56 Bus. Law. 1287, 1314 n. 107 (2001); Stroud.

The one opinion running somewhat to the contrary is the recent Chancery Court case in *Mercier v. Inter-Tel*, in which the board delayed a shareholder vote on a merger. Vice-Chancellor Strine held that *Blasius* did not apply to the board action. He proceeded, however, to hold in the alternative that the board's good faith action met the standard, at least as to a short delay, because shareholders were about to act against their own interests, because they had not had sufficient time to digest new information, and because the acquirer would likely walk away if shareholders voted no. Inter-Tel at 819. "When directors act for the purpose of preserving what the directors believe in good faith is a value-maximizing offer, they act for a compelling reason in the corporate context." Id. The alternative holding in *Inter-Tel* has to be viewed in light of the peculiar nature of the board action, which amounted only to a small brake on shareholders' ability to take action, necessitated by the need to analyze new information, but which left the ultimate decision in shareholders' hands.

But even if *Blasius* does not technically apply, it is unclear what follows. Some Delaware precedent suggests that even under *Unocal/Unitrin*, the same "compelling justification" test would apply.[87] Thus, the Delaware Supreme Court stated in *Stroud*, "A board's unilateral decision to adopt a defensive measure touching 'upon issues of control' that purposefully disenfranchises its shareholders is strongly suspect under *Unocal*, and cannot be sustained without a 'compelling justification.'"[88] Whether this dictum in *Stroud* will be followed in other cases is yet another important question under Delaware law.

D. The Best Argument in Support of the Deal: The "Zone of Insolvency"

How, then, might the Amended Merger and SEA be defended under Delaware law? The strongest argument that could be made is that, because BSC was on the verge of insolvency, the independent and non-conflicted board had additional discretion to act to ensure that the corporation would be able to meet its obligations to its creditors, employees and customers, even at some cost to shareholders.[89] Going back at least to the *Credit Lyonnais* case in 1991, Delaware has made clear that when a corporation is operating "in the vicinity of insolvency, a board of directors is not merely the agent of the residue [sic: residual] risk bears, but owes its duty to the corporate enterprise."[90] In that case, the court held, the board had an obligation "to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity"[91] rather than merely to maximize the benefit to be obtained by the shareholders.

As Vice Chancellor Strine explained in *Production Resources*, *Credit Lyonnais*, despite some of the scholarly commentary and a few court decisions, was not about expanding creditors' rights or providing them with a new cause of action, but rather was about recognizing that the business judgment rule protects directors in choosing a less risky course of action: "In other words, *Credit Lyonnais* provided a shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk so long as the company would not technically breach any legal obligations."[92]

So, too, in the case of BSC, the board would argue that the firm was on the ropes, that the one chance to save it from bankruptcy was the deal with JPM; that, although shareholders were understandably upset, there was really no alternative to the Amended Merger including the SEA; and that the doctrine announced in *Credit Lyonnais* would shield them from an attack by shareholders that they pursued an action that did not maximize shareholder benefit.

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[87] Inter-Tel, 929 A.2d at 810-11.
[88] Stroud, 606 A.2d at 91 n. 3.
[89] Credit Lyonnais Bank Nederland, N. V. v. Pathe Communications Corp., 1991 Del. Ch. LEXIS 215, 1991 WL 277613 (Del. Ch. Dec. 30, 1991); Production Resources; see, also, Gheewala at __. (citing and discussing Production Resources favorably).
[90] Credit Lyonnais at TAN 55.
[91] Id.
[92] Production Resources at __.

This argument, however, seems somewhat misdirected in the BSC context. First of all, a recent Delaware Supreme Court decision has clarified that the duty of board shifts only when a corporation is *actually* insolvent. As the court recently held, "When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation *for the benefit of its shareholder owners*."[93]

Second, at least based on publicly available information, it is quite uncertain whether in fact BSC was insolvent (or, for that matter, within the zone of insolvency) on March 24, at the time of the Amended Merger Agreement. The price paid by JPM (about $1.45 billion[94]), and JPM's eagerness to assure approval of the deal at that price, are both inconsistent with a claim of insolvency.[95] The events leading up to the Amended Merger Agreement also cast factual doubt on a claim of insolvency. To be sure, on March 16, when the original Merger Agreement was signed, BSC was in dire straits: it faced a run on the bank and impending bankruptcy if its customers and counterparties could not be assured of its liquidity. But the March 16 deal, combined with the JPM financing commitment and the Fed commitment to purchase $30 billion in illiquid securities from the previous Friday, provided sufficient liquidity for the company to continue doing business.[96] As of March 17, therefore, the immediate liquidity crisis was averted, BCS's stock price stabilized at about $5 per share,[97] and the market attention turned from the impending collapse of the financial system to the merits of the JPM deal. The Amended Merger Agreement, with its $10 price for BSC, was the result of a belief that the BSC board had given the company away for too little and JPM's accompanying fear that shareholders would vote down the deal. If BSC had truly been insolvent at that point, a shareholder threat to vote against the $2 deal would not only have lacked credibility, it would not have induced JPM to quintuple the offer price within a span of a few days.

That the $2 deal negotiated on March 16 was a steal for JPM, and that the $10 deal on March 24 was still pretty good, is also underlined by the stock price movements of JPM. On March 17, the first trading day after the $2 deal was announced, JPM's stock price increased by over 10% from $36.54 to $40.31.[98] Between March 17 and March 24, when the $10 deal was locked up, JMP stock price increased by a further 15% to $46.55.[99] Over this period, the market capitalization of JPM increased by $34 billion –

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[93] North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 101 Del.Supr.,2007 (emphasis added)

[94] Schedule 14A, Mar 18, 2008, at __ (145 million shares outstanding)

[95] A positive share price, standing by itself, does not necessarily indicate that the company is not insolvent at the time. Shareholder may hope for an improvement in the company's fortunes before the creditors have to be paid or to extract some value from even an insolvent entity through bargaining in bankruptcy. In the context of BCS, however, it would be odd for a solvent company like JPM to acquire BSC for $1.45 billion if BSC were insolvent.

[96] Kate Kelly, *Bear Stearns Neared Collapse Twice in Frenzied Last Days*, May 29, 2008, *Wall St. J.*, Page A1..

[97] Bear Stearns Ord Shs (BSC) – Stock Chart, Index Chart – MSN Money, http://moneycentral.msn.com/investor/charts/chartdl.aspx?Symbol=BSC..

[98] Id.

[99] Id.

surely a figure hard to square with the theory that JPM had just spent $1.5 billion to acquire an insolvent company.[100]

Third, the shareholders' complaint is not that choosing the JPM deal was, itself, a breach of the duty of care because it did not secure the highest price. Rather, the claim is that the SEA interfered with shareholders' *governance* rights: their statutory right to approve or reject a merger. Indeed, in *Credit Lyonnais*, in precisely the section quoted, Chancellor Allen noted in a footnote, "*But cf. Blasius Industries Inc. v. Atlas Corp.*, Del. Ch., 564 A.2d 651 (1988) (board action intended to impede stockholder exercise of statutory franchise right is suspect even if taken in good faith effort to promote corporate welfare)."[101] After all, shareholders' right to approve or reject a merger is statutory, not simply an implication of the normal case of directors owing fiduciary duties to the corporation and its shareholders. The board should not be permitted, under the guise of advancing the interest of the corporation and its creditors, to undermine this statutory right of the corporation's shareholders.

Indeed, *Omnicare* itself involved a firm on the brink of insolvency[102] in which the controlling shareholders, acting in good faith and without conflict of interest, committed to a merger that assured that all creditors would get paid, and in which all shareholders were treated equally. If a board were permitted to undermine shareholder voting rights for the good of the creditors of such a company, one would have expected the Delaware Supreme Court to have awarded the Omnicare directors a medal. Instead, the Supreme Court enjoined the voting agreements because they undermined the shareholder vote, rendering it a mere *fait accompli*. It is extremely hard to see how a judge could uphold the SEA on the "zone of insolvency" theory without first overruling *Omnicare* – which, despite its flaws, remains binding on the Delaware Chancery Court (as well as on any foreign court applying Delaware law).

Upholding the SEA on the basis that BSC was nearly or actually insolvent when it was entered into, and that this potential insolvency permits the board to ride roughshod over shareholders' governance rights, thus raises a host of factual and doctrinal difficulties. While this may be the best of the several bad ways to uphold the SEA, it would not present an easy way out for Delaware courts.

E. The 40% Exception

Another even less persuasive argument could be made in support of the SEA. One defense can be discerned in some (garbled) newspaper reports. The New York Times reported that "In an unusual move, Bear's board was seeking to authorize the sale of 39.5 percent of the firm to JPMorgan in an effort to move closer to majority shareholder approval. Under state law in Delaware, where the companies are incorporated, a company can sell up to 40 percent without shareholder approval."[103] In another account, it was said that "takeover practitioners have generally advised that as

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[100] The S&P 500 index slightly declined on March 17 and increased by less than 5% between March 17 and March 24.
[101] Credit Lyonnais at n. 56.
[102] At the time of the *Omnicare* decision, Delaware courts still used the zone of insolvency standard.
[103] Andrew Ross Sorkin, JPM in Negotiations to Raise Bear Stearns Bid, NYT March 24, 2008 at A1.

long as a deal was theoretically possible, Omnicare wasn't implicated. Delaware practitioners have settled on the '40 percent rule' to set a limit on how high you could go on a lock-up. Hence the 39.5 percent figure in Monday's deal with Bear."[104]

To start with, there is, of course, no such forty percent rule in Delaware law. As the second quote suggests, what seems to be intended here is a reference to a practitioners' rule of thumb with regard to the applicability of *Omnicare*. As discussed above, in *Omnicare*, the Delaware Supreme Court held that locking up the votes of sixty percent of the shares impermissibly rendered merger approval a fait accompli. But what percentage of the votes *can* be locked up *without* triggering *Omnicare*? The case, of course, did not say.

If one reads *Omnicare* as holding that you cannot lock up a "controlling" percentage of the votes – a reasonable reading as, in *Omnicare*, it was the votes of the controlling shareholders which were locked up, and which rendered the outcome a fait accompli – then the business planner's question becomes "what is the minimum percentage that gives control?" Here, the answer based on the existing cases is that, while there are a variety of cases, in a variety of contexts, finding control between 40% and 50% of the shares, there are no cases finding control below 40%.[105]

But, as a defense of the SEA, this is a pretty weak argument. First, *Omnicare* and the related case law all involved shareholders who *already* owned a controlling position. By contrast, in BSC, it is the Bear Stearns board, through the SEA, that unilaterally gave JPM its overwhelming stock holding. Second, the notion that anything short of 40% does not amount to a "fait accompli" may be practitioner lore but is not Delaware law (notwithstanding a single opinion involving specific facts by a respected judge). Third, there is no suggestion in the case law that one can issue up to 40% of the company's stock in a lock-up without running afoul of *Unocal/Unitrin.* Fourth, and most importantly, under the SEA, JPM was permitted to, and JPM did, acquire far more than 40%: it immediately purchased another 5% of BSC stock and then raised its stake to

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[104] Steven Davidoff, Is JPMorgan Getting Too Clever? NYT Deal Book (Deal Professor) March 24, 2008.

[105] Thus, for example, in management buyout cases in which the question is whether the *Kahn v. Lynch* entire fairness standard applies, 40% seems to be the lower bound. In Kahn v. Lynch Communications, 638 A.2d 1110, 1112 (Del. 1994) , Alcatel had 43.3% and was, in fact, restricted to appointing a minority of the directors of Lynch. In *In re Cysive*, the shareholding group, depending on how you counted shares and options, had somewhere between 41% and 44% which, according to the court, was sufficient to trigger entire fairness. In re Cysive, 836 A.2d 531, (Del. Ch. 2003). By contrast, in In re Western National Shr. Litigation, 46% was not enough to trigger entire fairness. In re Western National Corp. Shr. Litigation, 2000 Del. Ch. LEXIS 82 (Del. Ch. May 22, 2000).

There are other cases that are consistent with this 40% line. For example, in *IXC*, then Vice Chancellor (now Chief Justice) Steele, who dissented in *Omnicare*, held that agreements locking up 40% of the votes did not "make the outcome of the vote a foregone conclusion." In re IXC Communications, Inc. Shareholder Litigation, 1999 Del. Ch. LEXIS 210. In *ACE v. Capital Re*, a case involving a topping bid and the question whether Capital Re should be enjoined from talking with the competing bidder, the fact that ACE controlled nearly 46% going into the merger vote counted strongly towards interpreting the merger agreement to permit Capital Re to talk with other potential bidders. ACE v. Capital Re, 747 A.2d 95 (Del. Ch. 1999).

49.73% of the outstanding shares over the next few weeks, a level which gives de facto control.

F. Summary

In the end, therefore, we believe that to uphold the SEA, the Delaware courts would have to engage in significant factual or doctrinal contortions. Even if *Blasius* does not apply, a conclusion that could easily be reached on existing precedent, the SEA would have to survive *Unocal/Unitrin* and *Omnicare.* To get there, the courts could either overrule *Omnicare* (as noted, it was a split opinion and widely critiziced) or limit it to instances where the controlling shareholder has an actual majority (and not just 49.7%) of the stock; and further claim that a 39.5% share issuance, couple with no restrictions on further acquisitions, and accompanied by an actual purchase of another 10% of the stock within days and weeks, is not a preclusive and coercive device – a ruling that would not only be ridiculous, but which would greatly expand the permissible scope of defensive devices. Or they could find that the special circumstances of the case – the national interest – permitted the board to engage in conduct that would otherwise violate their fiduciary duties – introducing a novel and alien concept into Delaware corporate law. Or they could find that, despite JPM's eagerness to acquire BSC for $1.5 billion, BSC was insolvent, and hold, as a matter of first impression (and at least implicitly inconsistent with *Omnicare* and dicta in *Credit Lyonnais*), that a board of an insolvent company can coerce shareholders into approving a deal that it finds in the overall best interest of shareholders and creditors – a resolution that, in our view, is questionable both on the interpretation of the fact and in the merits of the new doctrine it creates, but that could still be the least bad of the ways to uphold the SEA.

IV. Delaware's Dilemma

The Amended Merger Agreement and Share Exchange thus placed Delaware on the horns of a dilemma. On the one hand, the SEA is pretty clearly invalid under current Delaware law. On the other hand, how could Delaware even contemplate enjoining a transaction that was supported, indeed, arguably driven and financed by the Federal Reserve with full support of the Treasury, a transaction that may have been necessary to prevent a collapse of the international financial system? What would happen if a Delaware court enjoined the merger? Would the Federal Reserve or the Treasury or the defendants seek to remove the case to federal court (on some theory or other)? How could little Delaware insist on shareholders' right to veto a merger when so much depended on its approval? Suppose that Delaware enjoined the merger, Bear Stearns failed, and the international financial system did, in fact, collapse. While upholding the SEA would involve a host of problems, risking the collapse of the financial system by invalidating the Share Exchange could provoke exactly the kind of attention to Delaware's lack of political legitimacy and induce doubts about Delaware's ability to handle its role as maker of national corporate law, that would constitute a severe threat to Delaware's franchising business.

This was the dilemma that faced Vice-Chancellor Donald Parsons when he was assigned the Delaware piece of the Bear Stearns litigation.[106] As the earlier time line indicated, on March 17 and 18, four separate class actions were filed in New York, with a fifth filed on March 20. On March 20 and 24 (the day that the Amended Merger Agreement and SEA were announced), two class actions were filed in Delaware. On March 27, the defendants moved to stay the Delaware action in favor of the New York actions.[107] In this Part, we first discuss the general approach Delaware has taken in deciding whether to stay an action involving Delaware corporate law. We then turn to Vice-Chancellor Parson's ruling in the BSC case.

A. Delaware's Role in Adjudicating Delaware Corporate Law

In deciding on whether to stay a Delaware action, Delaware considers a variety of factors. If the Delaware action is the only action filed, and the stay is sought on the grounds of *forum non conveniens*, Delaware rarely grants such relief.[108] If another action is filed in another court, Delaware first examines whether the Delaware action is filed first, the other action is filed first, or the cases were filed contemporaneously. Delaware considers cases filed within a few days of each other to have been filed contemporaneously.[109]

If the non-Delaware action is filed first, Delaware applies the so-called *McWane* test. Under *McWane,*[110] a decision to grant a stay should be exercised freely in favor of a prior action as long as that action involves the same parties and issues and the other court is capable of doing prompt and complete justice.[111]

On the other hand, if the two actions are filed contemporaneously, or the Delaware action was filed first, the court engages in a forum *non conveniens* analysis. Under that analysis, Delaware considers the standard factors:

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[106] In re the Bear Stearns Companies, Inc. Shareholder Litigation, 2008 Del. Ch. LEXIS 46.

[107] There is a separate and interesting question as to why the defendants preferred a New York forum. From a purely doctrinal perspective, they would be better off in Delaware. As discussed above, the case that presented the most serious obstacle to the validity of the SEA was *Omnicare*, a 3-2 decision of the Delaware Supreme Court. In a Delaware forum, one could argue that *Omnicare* was wrongly decided and should be overruled. By contrast, in a New York forum, the court would have to take *Omnicare* as stating current Delaware law, and would have no way to take judicial notice of the controversy over its continued validity.

On the other hand, only a Delaware Chancellor, with a full and confident grasp of Delaware doctrine, and experience adjudicating high stakes corporate battles, would have had the self confidence to even consider enjoining such a merger. See, e.g, IBP, Inc. v. Tyson Foods, Inc., 789 A.2d 14 (Del. Ch. 2001)(specific performance of a $3 billion merger ordered); Scott Kilman and Robin Sidel, Judge Rules Against Tyson in IBP Takeover Case, WSJ June 18, 2001 at A3. Our guess is that it was this consideration that ultimately drove the decision to seek adjudication in a New York forum.

[108] McWane v. McDowell-Wellman Engineering Co., 263 A.2d 281, 283 n. 2 (Del 1970).

[109] Cite.

[110] Id.

[111] Id. at 283; Adirondack GP, Inc., v. American Power Corp., 1996 Del. Ch. LEXIS 143.

> (1) the applicability of Delaware law, (2) the relative ease of access to proof, (3) the availability of compulsory process for witnesses, (4) the pendency or non-pendency of a similar action or actions in another jurisdiction, (5) the possibility of a need to view the premises, and (6) all other practical considerations that would make the trial easy, expeditious, and inexpensive.[112]

This doctrinal framework governs stay motions in Delaware generally, regardless of whether the case involves Delaware corporate law or other matters. However, in cases involving Delaware corporate law, the factors play out differently. Our review of stay cases in corporate law decided in the last five years reveals the following pattern:

(i) Where the non-Delaware action is filed first and the action relates to a corporation that is not publicly traded, Delaware will generally stay the Delaware action.[113]

(ii) Where the non-Delaware action is filed first but the action relates to a publicly traded corporation, Delaware will sometimes issue a stay (when special facts would make it inefficient to proceed in Delaware)[114] and sometimes not.[115]

(iii) Where the actions are contemporaneous or the Delaware action is filed first, Delaware will generally not issue a stay, especially if the action involves a publicly traded corporation. Within the last category, we found three actions involving a public corporation, and Delaware refused the stay the Delaware action in each.[116] We found one action involving a non-public corporation and Delaware issued a stay, but that case involved two unusual facts. First, the same party instituted two actions in different courts. Thus, the stay did not depive the party instituting the Delaware action of its choice of forum. Second, only the non-Delaware forum (Pennsylvania) had personal jurisdiction over one of the key defendants, who had been dismissed from the Delaware action for lack of jurisdiction.[117]

When Delaware refuses to issue a stay, it frequently bases this decision on the first of the *forum non conveniens* factor – the applicability of Delaware law – sometimes noting the importance of Delaware developing its case law, especially when the issues

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[112] Ryan v. Gifford, 918 A.2d 341, 351 (Del. Ch. 2007), quoting *In re Chambers Dev. Co. S' holder Litig.*, 1993 Del. Ch. LEXIS 79, 1993 WL 17933, at *6.; In re Bear Stearns at X.

[113] See, e.g., Citrin Holdings v. Cullen, 2008 WL 241615 (Del. Ch.).

[114] See, e.g., Kaufman v. Kumar, 2007 WL 1765617 (Del. Ch.) (New York action filed 2 years before Delaware's); Teachers' Retirement System of La. V. Scrushy, 204 WL 423122 (Del Ch.) (Del. Action filed after plaintiffs in Alabama state and federal courts, together with plaintiffs in a prior Delaware action, had reached agreement on appointment of steering committee, appointment of lead counsel, and supervised settlement discussions); Brudno v. Wise, 2003 WL 1874750 (Del. Ch. 2003) (Del. action stayed where derivative Delaware claim hinges on the outcome of a securities claim in federal action and the federal courts had stayed the federal derivative action pending the disposition of the securities claim).

[115] Ryan, supra n. XX (no stay since action involves novel and substantive issue of Delaware corporate law); Biondi v. Scrushy, 820 A.2d 1148 (Del. Ch. 2003) (not stayed since prior filed complaint was cursorily plead).

[116] In re Topps; Rapoport; and Brandin v. Deason, 941 A.2d 1020 (Del. Ch. 2007).

[117] Cornerstone Tech. v. Conrad, 2003 WL 1787959 (Del. Ch.).

raised in the case are novel and substantial.[118] Thus, for example, in *Ryan v. Gifford*, Chancellor Chandler denied a motion to stay an option backdating case in favor of an earlier filed case pending in federal court and held that:

> A similarly important factor in determining whether a stay is appropriate in a derivative action is a court's ability to render justice. Rendering justice necessarily entails accurately applying controlling law, in this case Delaware law. In many instances, this Court has recognized without hesitation that sister state courts and federal courts are capable of applying Delaware law and providing complete justice to parties. [FN12: *In re Westell Techs., Inc.,* 2001 Del. Ch. LEXIS 161, 2001 WL 755134 (Del. Ch. June 28, 2001).] At the same time, however, Delaware courts have a "significant and substantial interest in overseeing the conduct of those owing fiduciary duties to shareholders of Delaware corporations." [FN13: *In re Chambers Dev. Co. S'holder Litig.,* 1993 Del. Ch. LEXIS 79, 1993 WL 179335, at *8 (Del. Ch. May 20, 1993). 14 1993 Del. Ch. LEXIS 79, [WL] at *9.] This interest increases greatly in actions addressing novel issues. In *In re Chambers Development Co.,* this Court noted, as it has in the past, that "novel and substantial issues of Delaware corporate law are best resolved in Delaware courts." [FN14 1993 Del. Ch. LEXIS 79, [WL] at *9.] Thus, while the application of Delaware law in most cases is not determinative, more weight must be accorded to this factor where the law is novel. Such is the case here.[119]

Note that Delaware has taken a fairly broad view of what constitutes a novel or substantial issue. Thus, in *Rapoport v. Litigation Trust,* [120] Vice-Chancellor Parsons found that the

> action will likely raise at least one novel issue in Delaware corporate law: whether directors and officers' duties change materially in the face of 'deepening insolvency. This action also raises "substantial issues" of Delaware corporate law. Indeed, the liability or lack thereof of the Directors will turn on their compliance with the duties of good faith and loyalty, as elucidated by the Delaware courts.

The Delaware practice we have described, we believe, reflects a view of the proper scope of Delaware jurisdiction held not only by the Delaware judiciary, but shared by the corporate litigation bar and corporate law academics. This view takes as a starting point that publicly traded companies incorporate in Delaware (and pay its high franchise taxes) at least in part because of its high-quality and specialized courts and, as a general matter, want important and high-profile cases to be decided by Delaware judges. The Delaware court system involves a highly respected Chancery Court that decides cases without juries and specializes in corporate law adjudication, combined with a Supreme Court that offers quick review and brings its own considerable expertise – three of the five current Supreme Court justices are former members of the Chancery Court and all regularly hear

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[118] *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 1985 Del. Ch. LEXIS 545, *4, Del. Ch., C.A. No. 8126, Walsh, J. (October 9, 1985), cited in Chambers at *9.
[119] Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007).
[120] 2005 WL 3277911 (Del Ch. 2005).

appeals from the Chancery court on corporate law issues. The judges on the Delaware courts are not only experts, but are few in number and communicate regularly with each other and members of the corporate bar. There is thus a lot that is understood in Delaware doctrine that is written between the lines of the judicial opinions.

Compounding these aspects of the court system, Delaware corporate law doctrine regularly employs open-ended highly fact-specific standards that are difficult to apply by any judge who does not regularly adjudicate corporate law disputes.[121] It is a doctrine that works well for the Delaware courts – because of the small number and the expertise of its judges -- but much less well if judges on other courts are asked to apply it. As a result, any issue arising under Delaware corporate law where the correct outcome is not obvious is best decided by Delaware's judiciary.

Indeed, despite the fact that Delaware courts pay lip service to the ability of other courts to decide Delaware corporate law cases (and let them decide cases involving non-public corporations that are usually low profile and unimportant to the development of Delaware doctrine), the fundamental view that non-Delaware judges should not decide important issues under Delaware corporate law is occasionally revealed. Thus, again in *Rapoport*, Parsons continued to explain that "such questions of substantive Delaware corporate law 'are more properly decided here, rather than another jurisdiction'"[122] In *Brandin*,[123] Vice-Chancellor Lamb, after first noting that "federal courts are quite capable of deciding cases involving Delaware corporate law", proceeded to quote then U.S. Supreme Court Justice White for the proposition that federal court would have an unavoidable tendency "'to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system.'"[124] And in another notable case, *In re Topps*, Vice Chancellor Strine noted that in Delaware, only "ten judges are involved in [corporate law] decision, avoiding phenomena such as 'circuit splits'" and expressed concern that the "important coherence-generating benefits created by [the Delaware judiciary] .. are imperiled if .. decisions are instead routinely made by a variety of state and federal judges who only deal episodically with our law."[125] In case someone missed the point, he then quoted at length from an article by our colleague Bob Thompson praising the Delaware courts for the unmatched coherence of its fiduciary duty law.[126]

The refusal by Vice-Chancellor Strine to stay the Delaware action in *In re Topps* is especially noteworthy because, as in the BSC case, the non-Delaware action was pending in the New York Supreme Court in front of Justice Cahn. Despite Strine's suggestions that New York should respect Delaware superior interest and stay its action – including a quote from Judge Learned Hand, "one of New York's most distinguished jurist" that "'when a trial involve[s] the internal affairs of a corporation, the rule is that

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[121] Edward Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 U.C.L.A. L. Rev. 1009 (1997).
[122] Rapoport at __, quoting __.
[123] Brandin, 941 A.2d at 1027.
[124] Id. at at __, quoting __.
[125] *In re The Topps Co. S'holders Litig.*, 924 A.2d 951 (Del. Ch. 2007).
[126] Id. At fn. 24.

the courts of a foreign forum will not assume jurisdiction over it'"[127] – Justice Cahn refused to issue a stay. He held that, under New York law, when the first action was filed in New York—even if only by a day --, and New York has a substantial nexus with the case, New York should never stay, even in favor of the state of incorporation.[128] For Justice Cahn, then, a decision to incorporate in Delaware does not reflect a choice by the corporation and its shareholders of Delaware as the preferred forum for adjudicating corporate law disputes that should be accorded significant weight.

Justice Cahn's reasoning has the potential for severely undermining Delaware's ability to resolve disputes. In virtually *every* dispute, another state will have a substantial factual nexus to the action, and one this is stronger than Delaware's. After all, Delaware is rarely the state where companies are headquartered, where financial advisors are located, where deals are negotiated, where board meetings are held, or where the key documents and witnesses are located. Indeed, given New York's status as the financial capital, most cases will have a stronger nexus to New York than to Delaware. If Justice Cahn's reasoning were accepted, none of these cases would be adjudicated in Delaware if a non-Delaware action is filed even one day (or one hour) before the Delaware action.

But the ability of Delaware to decide cases raising questions of Delaware corporate law is a matter of enormous consequence to Delaware. Reducing the ability would, even in the short run, diminish Delaware's attraction as state of incorporation and reduce the income of Delaware's corporate litigation bar, an important political constituency. In the long run, the consequences would be even more drastic. Delaware law would be less developed (due to the smaller number of cases), possibly become less coherent (due to the presence of decisions decided by other courts), and its judiciary could loose part of its expertise (due to the smaller number of cases heard). From Delaware's perspective, Justice Cahn's approach thus constitutes a virtual declaration of war on its corporate law adjudication.

B. The Delaware Motion for a Stay

As a matter of Delaware law and practice, therefore, it would have been quite straightforward for Vice Chancellor Parsons to deny the motion to stay. After all, this was a case in which the parties themselves, in the Merger Agreement and the SEA, had explicitly contracted for Delaware law *and* a Delaware forum.[129] Moreover, as the discussion above shows, the case presented questions at least as novel and substantive as those cited in prior cases as justification for a refusal to issue a stay. Thus, a refusal to stay this high profile case involving a publicly traded corporation would be consistent with the intention of the parties, with Delaware doctrine, and with Delaware's past practice. By contrast, yielding to Justice Cahn's assertion of New York adjudicative

[127] Id. At 959.
[128] In the Matter of The Topps Co., Inc. Shareholder Litigation, 2007 NY Slip Op 52543U; 19 Misc. 3d 1103A; 2007 N.Y. Misc. LEXIS 8973; 237 N.Y.L.J. 117 (2007).
[129] Merger Agreement, §9.7; SEA, 8.6

authority in a case involving the internal affairs of a Delaware corporation would not be a viable long-term strategy for Delaware.

But Vice-Chancellor Parsons stayed the Delaware action. In doing so, he made several arguments. First, he stated that:

> Despite Plaintiffs' protestations to the contrary, the claims asserted in the Complaint only require the application of well-settled principles of Delaware law to evaluate the deal protections in the merger and the alleged breaches of fiduciary duty. There is no dispute that these principles will be applied by some court. Although the facts of the case are unusual, the uniqueness of facts does not transform settled law into new or novel legal issues. [130]

This, we assert, is disingenuous. Some of the relevant principles are hardly settled: the split decision in *Omnicare* is one of the most controversial opinions to be issued by the Delaware Supreme Court in years; the applicability of *Blasius* to merger cases is unresolved and the scope of the "compelling justification" exception under *Blasius* is almost completely undefined; and the scope and content of a "zone of insolvency" defense is especially unclear in light of the recent *Gheewala* case. And even with respect to purportedly settled principles, this case raised the question of whether they should be unsettled to permit a transaction, arguably necessary to maintain the stability of the financial system, to proceed and, if so, on what basis?. One might think that the expert Delaware judiciary should decide these questions.

Vice-Chancellor Parsons then added:

> Moreover, several facts make it unlikely this extraordinary situation will recur or have wide application. Indeed, Christopher Cox, Chairman of the Securities and Exchange Commission, in reported testimony before a Congressional Committee characterized Bear Stearns' failure to obtain financing even though it had "high quality collateral" as "an unprecedented occurrence." [131]

This, we submit, is a makeweight. First, the fact that it was unprecedented does not mean that it will not recur. With other financial institutions in distress, we can only hope that another major firm does not find itself in similar straits. Second, and more importantly, the core of the issue presented – to what extent can dire circumstances justify the board's good faith usurpation of shareholders' statutory right to approve a merger by issuing a large block of shares to a merger partner – is a matter of central and widespread importance for Delaware corporations.

As yet another basis for the stay, Vice Chancellor Parsons asserted:

> That is not to say, however, that the issues of Delaware law presented by this dispute are not important; in fact, such issues ordinarily would be heard in this

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[130] *In re The Bear Stearns Companies Inc. Shareholder Litigation*, 2008 *Del. Ch. LEXIS* 46, *21 (2008)..
[131] Id.

> Court. Rather, I find the circumstances of this case to be *sui generis*. What is paramount is that this Court not contribute to a situation that might cause harm to a number of affected constituencies, including U.S. taxpayers and citizens, by creating the risk of greater uncertainty. [132]

The logic of this argument is somewhat unclear. The procedural posture of the case, with parallel actions filed in two fora, is common and surely not *sui generis*. What makes this case *sui generis* is the significance of the Bear Stearns-JPM transaction for the stability of the financial system. But if this aspect of the case is legally irrelevant – if the outcome under Delaware law is not and should not be affected by it – then the fact that this aspect is *sui generis* should also have no impact on the decision to stay either. After all, each case involves facts that are *sui generis* in some sense, yet legally irrelevant. If, on the other hand, this aspect is, or is arguably, legally relevant, then the case raises novel issues and therefore cannot be governed by well-settled principles of Delaware law. And the presence of novel issues is a factor that, under Delaware stay jurisprudence, would weigh heavily in favor of having the case heard in a Delaware court.

Moreover, it is unclear why a failure to stay the case would create the risk of greater *uncertainty*. First, of course, this presupposes that New York would proceed with the case despite Delaware's failure to stay. In *Topps*, Vice-Chancellor Strine refused a stay and left New York to decide for itself what to do.[133] In *Bear Stearns*, Parsons might have done the same thing.

But even assuming that Justice Cahn would not stay the New York action, proceeding in two fora rather than one does not materially increase *uncertainty*. The issue arises at the intersection between parallel representative litigation, the U.S. Constitution's "full faith and credit clause"[134] and the parallel federal "full faith and credit" statute.[135] Before final judgment, rulings of one court do not bind a court of a sister state.[136] By contrast, after a final judgment, straightforward application of the rule of res judicata generally bars the relitigation of the case in the sister state court.[137] The Full Faith and Credit Clause, the Full Faith and Credit Statute and the Uniform Enforcement of Foreign Judgments Act, if applicable, provide additional compulsion to

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[132] Id. at *23.

[133] The New York court denied defendants' motion for a stay. In the Matter of The Topps Co., Inc. Shareholder Litigation, 2007 NY Slip Op 52543U; 19 Misc. 3d 1103A; 2007 N.Y. Misc. LEXIS 8973; 237 N.Y.L.J. 117 (2007).

[134] U.S. Const. art. IV, 1 ("Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof.").

[135] 28 U.S.C. 1738 (1994) (requiring state courts to give judicial proceedings of other states "the same full faith and credit ... as they have by law or usage in the courts of such State ... from which they are taken"). Geoffrey Miller, Overlapping Class Actions, 71 N.Y.U. L. Rev. 514 (1996). See also William T. Allen, Finality of Judgments in Class Actions: A Comment on Epstein v. MCA Inc., 73 N.Y.U. L. Rev. 1149 (1998).

[136] Miller at 523-525.

[137] Id. at 525-26. The two principal exceptions relate to absent class members who have not had adequate notice and right to opt out, Phillips Petroleum Co. v. Shutts, 472 U.S. 797 (1985), and absent class members who can show that they were not adequately represented by class counsel, . Id. at 526.

respect the first judgment.[138] This set of rules has the obvious effect of providing an incentive for a race in which the first judgment will prevail against all subsequent judgments in parallel proceedings.[139]

Within this framework, the most significant result of parallel Delaware and NY proceedings is to increase the likelihood of an injunction by giving plaintiffs the proverbial two bites at the apple: an injunction in either court will be binding on the parties, and a refusal to grant an injunction in either court will not bind the other court, because it is not a final judgment. This is presumably the main reason why JPM wanted to stay the Delaware action. There is thus a limited and trivial sense in which a stay increases certainty: with a stay, JPM only needs to win in NY; without a stay, JPM must win in both NY and Delaware.

But even the possibility of conflicting rulings is more imagined than real. If Delaware were to rule first on the preliminary injunction motion (as it was urged to do by the plaintiffs during the oral argument on the stay),[140] it would take quite a bit of chutzpah for the New York trial court to correct the Delaware Chancery court (or the Delaware Supreme Court if it had affirmed) on its application of Delaware law to the facts at bar. Moreover, if one accepts the premise that Delaware courts are more likely to decide the case correctly, and further believes that the earlier Delaware ruling will affect any subsequent New York ruling, Delaware's decision to stay merely increased the likelihood of an *incorrect* outcome by letting New York proceed without first hearing the views of the Delaware Chancery Court.

But what if New York were to rule first or make a decision without regard to the prior Delaware ruling? Even then, a Delaware stay will affect the outcome only if Delaware would have granted the injunction and New York does not. (If New York grants an injunction, or if New York does not and Delaware would not have granted one either, a Delaware stay has no effect on the outcome.) In this specific circumstance, to be sure, a Delaware stay reduces the likelihood of the SEA being enjoined and benefits JPM. But from a broader perspective, and assuming again that Delaware is more likely to decide the case correctly, a Delaware stay raises the likelihood of an incorrect ruling in this specific circumstance as well as in the case in which a prior Delaware ruling would affect the New York ruling. This combined effect – a lower likelihood of an injunction and a higher likelihood of an incorrect ruling -- seems desirable to us only if one believes that it is more important to have the merger consummated than to arrive at the correct legal outcome.

Finally, Vice Chancellor Parsons noted:

> This case raises practical considerations far beyond the typical concerns. The practical considerations here include: two sets of plaintiffs in two fora; the risk that inconsistent rulings would negatively impact not only the parties involved,

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[138] Id. at 526.
[139] Id. at 527.
[140] If Delaware enjoined the SEA, the injunction motion in New York would become moot.

> but also the U.S. financial markets and the national economy; and the involvement of unusual third party players, including, *inter alia*, the Federal Reserve Bank and the Department of the Treasury. Given these important and atypical practical considerations, this is the rare case where a stay may be appropriate.[141]

But this explanation is problematic. Stay motions often involve two sets of plaintiffs in two fora. That this case is highly important for the economy, as indicated by the involvement of Fed and Treasury officials, means not just that one should avoid the risk of inconsistent rulings (which, as explained before, is not so severe to start with and could be managed by having Delaware rule first), but that it is very important to get the case resolved correctly. Moreover, getting a difficult Delaware corporate law case resolved correctly is a factor that weighs heavily towards having it resolved by the Delaware Chancery and Supreme Court, and not within the New York state court system. At most, this argument supports an expedited schedule in Delaware.

Nevertheless, Vice Chancellor Parsons, when presented by the defendants with an opportunity to defer to another state, embraced it. And, in doing so, we argue, he made the right strategic decision for Delaware. The BSC dilemma placed Delaware in an impossible position. While it clearly could not – as a matter of prudent public policy and *Realpolitik* – enjoin the merger, upholding the SEA would have raised a host of its own problems. How to avoid the horns of the dilemma? Delaware hit on the perfect solution: by avoiding any decision at all!

By taking advantage of the pendency of actions in New York and defendants' motion to stay, by invoking the doctrines of comity and *forum non conveniens* to allow a New York trial court judge to decide a pure question of Delaware corporate law, Delaware managed to dodge both bullets. On the one hand, it could predict that the New York judge would not enjoin the transaction for a similar set of reasons that would lead Delaware to refrain from enjoining such a deal. On the other hand, any decision approving the merger would have no precedential value in Delaware and thus would not disturb its case law.[142] And if the New York court were to distort the facts to reach such a decision, it would matter even less for Delaware.

Moreover, this strategy trumps the alternative ways of ducking the question. For example, Vice Chancellor Parsons could have refused to enjoin the vote and waited to see if JPM's shares proved pivotal to the outcome.[143] But what if, but for the JPM shares, the merger did not receive shareholder approval? Then he would have been stuck. Alternatively, he might have played for time, hoping the case would settle or otherwise go away. But this strategy would have at least two further downsides: first, the settlement value would depend on the court's ruling on shareholders' likelihood of success, so

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[141] *In re The Bear Stearns Companies Inc. Shareholder Litigation*, 2008 *Del. Ch. LEXIS* 46, *28 (2008).

[142] As Gil Sparks, a leading Delaware lawyer representing BSC, argued to Vice Chancellor Parsons, "a preliminary ruling – a preliminary ruling by a foreign court on Delaware law questions won't reshape our law. That is done by this Court and by our Supreme Court." Transcript at 12:7-10.

[143] For an example of this strategy, see CITE.

avoiding the issue might also impede settlement; second, it would undermine Delaware's well deserved and highly valued reputation for speed.

Did Delaware suffer any damage from refusing to decide? Probably not. While it is true that Delaware cannot routinely defer to the courts of sister states on cases involving Delaware law without undermining its preeminent role as the authoritative interpreter of its own law, a rare exception hardly threatens that dominance.

V. Implications for Corporate Federalism

The shotgun marriage of Bear Stearns and JP Morgan Chase, a match made by the Treasury and the Federal Reserve, presents a real time case study of Delaware's place in the U.S. corporate law making system. There are a number of lessons that can be drawn from the experience.

First, Delaware's treatment of the *Bear Stearns* litigation emphasizes the extent to which Delaware avoids the limelight in cases in which there is a danger of strong public criticism, a strategy that we have argued elsewhere reduces the risk of a backlash against Delaware's status as maker of de facto national corporate law.[144] Just as being out front on the corporate scandals, a la Elliot Spitzer, would have been very dangerous for Delaware, so, too, taking a leading role in the Bear Stearns matter would have been very dangerous, especially if something bad had happened.

Second, Bear Stearns posed particular problems for Delaware's determinedly old fashioned, apolitical style of adjudication.[145] Delaware decisions derive part of their legitimacy from being perceived as technical and apolitical.[146] In this regard, Bear Stearns was truly a no win situation: enjoining the deal would have landed Delaware in the middle of political debate; not enjoining the deal could have been viewed by insiders as a political, not a legal, decision and detracted from Delaware's continued legitimacy.

Third, the federal system, with numerous federal and state actors, permits Delaware to duck "hot potato" issues such as this one. Delaware sometimes finds it in its interest to duck such issues.[147] But ducking issues carries risks of its own: duck too many and you become irrelevant. Delaware, as this case shows, thus finds itself performing a very delicate balancing act: it must maintain its centrality in corporate law while avoiding high profile, politically charged, and potentially partisan controversies that could provoke a political reaction.

Finally, the case study highlights Delaware's complex relationship with other states, and stands as an exception. In general, Delaware is respectful to other states on

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[144] Marcel Kahan and Edward Rock, *Symbiotic Federalism*, supra note XX.
[145] Id.
[146] Kahan & Rock, *Symbiotic Federalism*, supra n. XX.
[147] Symbiotic Federalism at _.

matters outside what it views as core issues of Delaware law.[148] But Delaware also expects similar deference from other states with regard to matters that fall (in Delaware's assessment) within its legitimate sphere. Delaware has a firm view that matters relating to the "internal affairs" of Delaware corporations fall within its sphere and thus has been quite hostile towards California or New York attempts to encroach.[149] Indeed, Delaware has argued that the internal affairs doctrine may be constitutionally mandated.[150] Furthermore, as we have argued above, Delaware believes that its expert courts should decide "novel and substantial issues of Delaware corporate law."[151]

As both *Topps* and *Bear Stearns* indicate, Delaware is on a collision course with New York. That collision will come sooner rather than later if New York adheres to Justice Cahn's position that a New York court *may not* stay an action that was first filed in New York (even by a day), so long as there is a factual nexus to New York (and without regard to the state of incorporation). We expect that Delaware will largely ignore the refusal of New York to stay a first-filed action arising under Delaware law, and will proceed with its own process, while defending its ability to adjudicate claims by assuring that the Delaware case will be decided first and thus be entitled to receive "full faith and credit" in the New York courts. Delaware should be able to win any "race to final judgment" because its courts are more efficient to start with, and it has a speedier (and, relative to New York, fewer tier) appeals process.

But the Bear Stearns case was not the place to fight out that issue. The opportunity to dodge a bullet by letting Justice Cahn handle the case was sufficiently valuable for Delaware that it wisely chose to overlook what in other contexts would be viewed as overreaching by New York.

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[148] Id. at __.

[149] VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108 (Del 2005); McDermott Inc. v. Lewis, 531 A.2d 206 (Del. 1987); Topps; anything else?.

[150] VantagePoint Venture Partners 1996 v. Examen, Inc.

[151] *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 1985 Del. Ch. LEXIS 545, *4, Del. Ch., C.A. No. 8126, Walsh, J. (October 9, 1985).