Takeover Law and Practice

1999

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This outline describes the current legal and economic environment relating to takeovers, mergers and acquisitions and tender offers. The outline topics include a discussion of directors' fiduciary duties in managing the company's affairs and considering major transactions, the role of the directors in evaluating a change in control transaction, permissible means of protecting a preferred transaction, advance takeover preparedness and responding to hostile offers. Particular focus is placed on recent case law and developments in takeovers. This edition reflects developments through March, 1999.

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TABLE OF CONTENTS

Page

INTRODUCTION 1

I. Directors' Duties, Generally 4

A. The Three Standards of Review 4

1. Traditional Business Judgment Rule 4

2. Enhanced Scrutiny 8

3. Entire Fairness 10

B. Significant Cases 14

1. Stock Mergers, *QVC, Time* and *Society for Savings* 14

2. Enhanced Scrutiny: *Unitrin* 18

C. The Importance of Informed, Good-Faith Decisionmaking 21

D. Fiduciary Duties and Third-Party Bids 23

E. The Duty to Auction 25

F. Investment Bankers' Fairness Opinions 26

G. Good Corporate Governance and Fiduciary Duties 29

Page

II. The Sale of the Company: Change in Control and Non-Control Transactions 30

A. Fiduciary Duties in the Sale Context 32

1. *Revlon* Duties 32

2. Techniques for a Public Sale 32

a. Closed Auction 32

b. Market Check 33

3. The Business Judgment Rule and Selling the Company 34

4. Recent Delaware Statutory Amendments Relating to Merger Agreements 36

B. The Use of Special Committees in Sale of Control Situations 37

1. When Should a Special Committee Be Formed? 39

2. Workings of the Special Committee 40

C. Valuing Stock Consideration in Acquisition Proposals 41

1. Qualitative Factors: Short- and Long-Term Values 41

2. Other Constituencies 44

3. The Proper Role of Social Issues 45

Page

III. Protecting the Deal 45

A. Stock Options and Break-Up Fees...................... 46

B. Cash Put Provisions 48

C. "No-Shop" and "Window-Shop" Clauses........... 49

D. Management/Shareholder Voting Lock-ups........ 50

E. The Use of Protective Devices in Non-Control Transactions.. 51

IV. Advance Takeover Preparedness and Responding to Unsolicited Offers............................ 52

A. Rights Plans 54

1. The Basic Design... 55

2. Basic Case Law Regarding Rights Plans 56

3. Renewal of Rights Plans, Shareholder Proposals and the Economic Evidence.......... 58

4. The New Frontier: "Dead Hand" Pills and the Fleming By-Law............................... 60

B. Defensive Charter and By-Law Provisions.......... 69

C. Change of Control Employment Agreements...... 73

D. Passive Responses to Unsolicited Offers – "Just Say No" 74

E. Active Responses to Unsolicited Offers............. 75

1. White Knights and White Squires 75

2. Restructuring Defenses................................ 76

Page

3. Corporate Spin-Offs and Split-Ups 78

4. Use of an ESOP or SECT as a Takeover Defense 79

5. Regulatory Action 81

V. Pricing and Structural Issues in Business Combinations 82

A. Factors Influencing Choice of Structure............. 83

1. Tax Considerations...................................... 83

a. Direct Merger 83

b. Forward Triangular Merger.................. 84

c. Reverse Triangular Merger................... 84

d. Section 351 Transaction....................... 84

2. Accounting Issues: Purchase and Pooling 85

a. Pooling of Interests Accounting 85

b. New SEC Guidelines on Buybacks and Poolings 89

c. Push Down Accounting........................ 91

3. Other Factors 91

B. Timing 92

C. All-Cash Transactions 94

D. Pricing Formulae and Allocation of Market Risk in Stock Transactions 94

Page

1. Fixed Exchange Ratio 94

2. Fixed Value with Floating Exchange Ratio; Collars 95

3. Fixed Exchange Ratio within Price Collar 97

E. Walk-Aways 98

F. Fiduciary Duties and Price Decline 100

G. Derivative Securities and Market Risk: Post-Closing Value Assurance 100

H. Finding the Appropriate Pricing Structure 101

I. Hybrid Transactions: Stock and Cash 103

1. Possible Cash-Stock Combinations 104

2. Allocation and Oversubscription 105

VI. Mergers of Equals 108

A. The Advantages of an MOE Structure 109

B. Resolving the Key Governance Issues 110

C. The MOE Merger Agreement 114

D. Fiduciary Issues and Fairness Opinions in MOEs 115

E. Protecting the Deal 117

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1999

INTRODUCTION

The 1990s have witnessed a number of significant developments in both case law relating to corporate transactions and financial and strategic approaches to business combinations. Each of these developments adds complexity to the legal issues that arise in connection with mergers and acquisitions, tender offers and other major transactions.

The escalation in transaction activity over the past four years has highlighted the need for a board of directors to be fully informed as to its fiduciary obligations and for a company to be prepared to respond to unsolicited takeover offers. United States transaction activity continues to set new records. The value of announced mergers and acquisitions worldwide reached an all-time high of $2.602 trillion in 1998, exceeding 1997's prior record year by over $806 billion, as reported by Securities Data Co. Domestic mergers and acquisitions activity in 1998 — $1.749 trillion in deals announced — surpassed the 1997 volume ($1.056 trillion) by nearly 65%, despite a slow down in the third and fourth quarters of 1998. While the 1997 M&A activity was concentrated in the telecommunications, utility, broadcasting and banking sectors, the 1998 surge has been driven by mergers in the financial services, telecommunications technology and industrial sectors.

Strategic mergers have predominated over hostile takeover activity, although a number of large well-respected companies — such as IBM, Hilton, J&J, Norfolk Southern, Wells Fargo, Western Resources and Bank of New York — have made unsolicited or hostile offers for competitors in recent years. Hostile deals accounted for less than 3% of total deal volume in 1998. Stock rather than cash has been the predominant form of consideration. Stock was used as consideration in approximately 75% of announced deals in 1998 as compared with approximately 65% in 1997. The preference for equity is a result of a number of factors, including relatively high stock market values and the ability to account for a transaction as a "pooling of interests," avoiding the impact of

goodwill amortization on earnings per share. Indeed, in 1998, strategic mergers reached new peaks, with the announcement of NationsBank's merger with BankAmerica and the Citicorp/Travelers combination as well as the Exxon/Mobil merger, a transaction that constitutes the largest merger ever. Cross-border strategic deals have flourished as well, with Aegon's acquisition of Transamerica, British Petroleum's merger with Amoco, Vodafone's merger with AirTouch Communications, the Deutsche Bank/BT Alex. Brown transaction, and the Daimler Benz/Chrysler combination as prime examples.

Stock-for-stock mergers raise complex issues of valuation, price protection and market risk that must be considered by both the acquiror and the seller. In addition, strategic mergers are not immune from, and may actually attract, third-party attempts to acquire one of the prospective merger partners. This potential vulnerability has been demonstrated by Norfolk Southern's decision to make a hostile bid for Conrail after Conrail entered into a merger agreement with CSX, Western Resources' bid for Kansas City Power and Light after KCP&L entered into a transaction with Utilicorp United, WorldCom Inc.'s merger with MCI Communications, following British Telecommunications Corp.'s earlier bid, and Newmont Mining's hostile exchange offer for Santa Fe Pacific Gold after Santa Fe had entered into a deal with Homestake Mining. In the context of a stock transaction — particularly when, as is frequently the case, there are competing transactions — directors' traditional fiduciary duties, as well as the practical difficulties of accomplishing a transaction, are made more complex by the inherent uncertainties that arise in valuing consideration in the form of equity. Recent stock market volatility has focused attention on the impact of unexpected market developments on pending transactions. These issues are exacerbated in the unusually volatile context of high-tech/internet-related companies, where market capitalizations and reactions are sometimes difficult to understand or predict.

The heightened merger activity has been accompanied by increasing attention from the SEC and antitrust authorities. In the third quarter of 1998, Federal Trade Commission opposition resulted in the termination of both McKesson Corp.'s attempt to acquire AmeriSource Health Corp. and

Cardinal Health's merger with Bergen Brunswig Corp. The Department of Justice and the Pentagon successfully opposed the merger of aerospace companies Lockheed Martin Corp. and Northrop Grumman Corp. The popularity of "pooling-of-interest" accounting in recent business combinations has drawn increased scrutiny from the Securities and Exchange Commission and the Federal Accounting Standards Board. The SEC recently required both U.S. Office Products Co. and Corporate Express, Inc. to restate their stock-financed acquisitions using purchase accounting as opposed to their original pooling structure. Both FASB and the SEC appear to be planning to end the use of pooling of interests accounting as an acquisition accounting method.

The accelerated pace of mergers and tender offers, as well as spin-offs, buybacks and other restructuring transactions, has been accompanied by significant court decisions relating to fiduciary issues and takeover defenses. In some cases, these decisions reinforce well-established principles of Delaware case law regarding directors' responsibilities in the context of a sale of the company. In other cases, they highlight areas where other states' statutory provisions and case law may dictate a different outcome than would be obtained in Delaware or states that follow the Delaware model.

Part I of this outline reviews the central responsibilities of directors, including basic case law principles, in the context of business combinations and takeover preparedness. Part II focuses on various aspects of the sale of a company, including the impact of a change of control on the directors' obligations and options, and the methods of selling a company. Part III describes permissible ways of protecting a preferred transaction, including recent case law developments relating to termination, or "break-up" fees. Part IV summarizes and updates central elements of a company's advance takeover preparedness, particularly the critical role of rights plans in preserving a company's long-term strategic plan and protecting a company against coercive or abusive takeover tactics and inadequate bids. Developments concerning so-called "continuing director" or "dead hand" provisions in rights plans, as well as the so-called "Fleming By-Law" assault on rights plans, are also discussed. Part V treats the central tax, accounting and pricing alternatives, as well as market risk issues relating to pricing

formulae, in merger transactions. Part VI provides an overview of merger of equals transactions, which have played an increasingly significant role in industry consolidation.

I

Directors' Duties, Generally

The traditional business judgment rule remains the basic standard of judicial inquiry with respect to directors' decisions, with judicial review of directors' actions being enhanced in certain limited circumstances.

The business judgment rule, together with two other standards of review of board decisions that have been articulated by the Delaware Supreme Court, are discussed in Section A. The question of which of the standards applies is discussed in Section B.

A. The Three Standards of Review

1. Traditional Business Judgment Rule

The first of the three standards, the normal deference to board decisions granted by the Delaware courts, is embodied in the traditional business judgment rule. This rule applies to some but not all merger transactions. Under the business judgment rule, "directors' decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Ivanhoe Partners* v. *Newmont Mining Corp.,* 535 A.2d 1334, 1341 (Del. 1987) (citations omitted). *Accord, Cede & Co.* v. *Technicolor, Inc.,* 634 A.2d 345, 360-61 (Del. 1993); *Pogostin* v. *Rice,* 480 A.2d 619, 624 (Del. 1984); *Aronson* v. *Lewis,* 473 A.2d 805, 811-12 (Del. 1984); *Panter* v. *Marshall Field & Co.*, 646 F.2d 271, 293-95 (7th Cir.), *cert. denied,* 454 U.S. 1092 (1981); *Treadway Cos.* v. *Care Corp.,* 638 F.2d 357, 382-83 (2d Cir. 1980); *Johnson* v. *Trueblood,* 629 F.2d 287, 292-93 (3d Cir. 1980), *cert. denied,* 450 U.S. 999 (1981). In the case of a Delaware corporation, the statutory predicate for the business judgment rule is Delaware General Corporation Law Section

141(a), which provides that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors. . . ." 8 Del. Code Ann. § 141(a).

In cases where the traditional business judgment rule applies, directors' decisions are protected unless the plaintiff is able to carry its burden of proof in showing that the board has not met its duty of care or loyalty. *See, e.g., Aronson,* 473 A.2d at 812.[1]

Duty of Care. To demonstrate that a board has not met its duty of care, a plaintiff must prove that directorial conduct has risen to the level of "gross negligence," measured under the standards announced by the Delaware Supreme Court in *Smith* v. *Van Gorkom,* 488 A.2d 858, 874 (Del. 1985) ("*Trans Union*") (in the context of a proposed merger, directors must inform themselves of all "information . . . reasonably available to [them] and relevant to their decision" to recommend the merger); *see also Aronson,* 473 A.2d at 812 ("under the business judgment rule director liability is predicated upon concepts of gross negligence"). Delaware law permits directors

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[1] Under 8 Del. Code Ann. § 102(b)(7), a Delaware corporation may in its certificate of incorporation either eliminate or limit the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty, but such provisions may not eliminate or limit the liability of a director for, among other things, (i) breach of the director's duty of loyalty to the corporation and its stockholders, or (ii) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law. Many Delaware corporations have either eliminated or limited director liability to the extent permitted by law. The Delaware Supreme Court has ruled that the typical Delaware corporation charter provision exculpating directors from monetary damages in certain cases applies to claims relating to disclosure issues in general and protects directors from monetary liability for good-faith omissions. *Arnold* v. *Society for Sav. Bancorp, Inc.,* 650 A.2d 1270 (Del. 1994). Similar provisions have been adopted in most states. The limitation on personal liability does not affect the availability of injunctive relief.

in exercising their duty of care to rely on certain materials and information:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of his duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

8 Del. Code Ann. § 141(e). The core of the duty of care may be restated as the directors' obligation to act on an informed basis after due consideration of the relevant materials and appropriate deliberation, including the input of legal and financial experts. While Section 141(e) recognizes that directors may use outside experts to advise the board on significant legal and financial matters affecting their analysis, that provision cannot be read to permit the board to delegate its central responsibilities – the duties of loyalty and care – to other decisionmakers.

Duty of Loyalty. To show that the board has not met its duty of loyalty, a plaintiff must prove that members of the board engaged in "self-dealing" transactions. If directors appeared on both sides of, or derived an improper financial benefit from, a challenged transaction, the court will, as indicated below, ignore the business judgment rule, and place the burden on the board to defend the challenged transaction by showing that it meets the requirements of "entire fairness" to the company and its shareholders. *See Ivanhoe Partners,* 535 A.2d at 1341; *see also AC Acquisitions Corp.* v. *Anderson, Clayton & Co.,* 519 A.2d 103, 111 (Del. Ch. 1986) ("where a self-interested corporate fiduciary has set the terms of a transaction and caused its effectuation, it will be required to establish the entire fairness of the transaction to a reviewing court's satisfaction"); *Blasius Indus., Inc.* v. *Atlas Corp.,* 564 A.2d 651 (Del. Ch. 1988) (actions by board after a consent solicitation had begun,

designed to thwart the dissident shareholder's goal of obtaining majority representation on the board, violated the board's fiduciary duty).

The Delaware Supreme Court has traditionally defined the duty of loyalty in "broad and unyielding terms," *Technicolor,* 634 A.2d at 361, although it has not attempted to establish a bright-line test to determine when a director's self-interest will result in entire fairness review of the whole board's action. The court has indicated that "any" interest of a director in the transaction does not *per se* establish a breach of his duty of loyalty; rather, the director's self-interest must involve evidence of disloyalty. *Id.* at 363. The more difficult, and necessarily fact-specific, question is to determine when a single director's disloyalty will so infect the entire board's decision that the board loses the presumption of the business judgment rule.[2] On remand of the *Technicolor* case, Chancellor Allen of the Delaware Court of Chancery stated that he would apply the following test to determine when, based on a breach of the duty of loyalty by one or more (but less than a majority) of directors, entire fairness review is appropriate:

> In my opinion a financial interest in a transaction that is material to one or more directors less than a majority of those voting is "significant" for burden shifting purposes . . . when the interested director *controls or dominates* the board as a whole or when the interested director *fails to disclose his interest* in the transaction to the board and a reasonable board member would have

[2] Delaware statutory law creates a limited "safe harbor" for the participation of an interested director in board action. Section 144(a) provides that a director's self-interest will not void a transaction or contract if (i) the director discloses, or the board is otherwise aware of, the material facts of the director's interest and a majority of disinterested directors approves the action; (ii) a majority of shareholders similarly aware of the director's interest approves the action; or (iii) the transaction or contract is fair to the corporation as of the time it was authorized, approved or ratified by the board or the shareholders. 8 Del. Code Ann. § 144(a).

> regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction.

Cinerama, Inc. v. *Technicolor, Inc.,* 663 A.2d 1134, 1153 (Del. Ch. 1994) (emphasis added), *aff'd,* 663 A.2d 1156 (Del. 1995).

Although such a breach may result in entire fairness review, the business judgment rule remains the primary standard. Significantly, when the traditional business judgment rule applies, "the Court gives great deference to the substance of the directors' decision and will not invalidate the decision, *will not examine its reasonableness,* and 'will not substitute [its] views for those of the board if the latter's decision can be "*attributed to any rational business purpose*".'" *Paramount Communications Inc.* v. *QVC Network, Inc.,* 637 A.2d 34, 45 n.17 (Del. 1994) ("*QVC*") (emphasis added; citations omitted).

2. Enhanced Scrutiny

There are limited situations in which Delaware courts will not defer to board conduct under the traditional business judgment rule. These include the adoption of a defensive mechanism in response to an alleged threat to corporate control or policy, *see, e.g., Unocal Corp.* v. *Mesa Petroleum Co.,* 493 A.2d 946 (Del. 1985), and approval of a transaction involving a sale of control and/or a break-up of the company, *see, e.g.*, *QVC,* 637 A.2d 34; *Revlon, Inc.* v. *MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985). In these circumstances, board action is subject to judicial review under an "enhanced scrutiny" standard, which looks both to the board's process and its action. The decisional process, including the information relied on, must satisfy the court's enhanced standard. In addition, under the enhanced scrutiny test, the court, unlike its review under the traditional business judgment rule, will examine the reasonableness of the directors' decision.

Instead of benefiting from the presumption attending the traditional business judgment rule, directors who unilaterally

adopt defensive measures in reaction to a perceived threat carry the burden of proving that their process and conduct satisfy the enhanced *Unocal* standard.[3] *See, e.g., QVC,* 637 A.2d at 45; *Barkan* v. *Amsted Indus., Inc.,* 567 A.2d 1279 (Del. 1989). This standard requires, in the context of a defensive device or transaction, that the board meet a two-pronged test: first, the board must show that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," which may be shown by the directors' good faith and reasonable investigation; and, second, the board must show that the defensive measure chosen was "reasonable in relation to the threat posed," which may be demonstrated by the objective reasonableness of the course chosen. *Unocal,* 493 A.2d at 955. If the directors can establish both prongs of the *Unocal* test, their actions receive the protections of the business judgment rule. Although in comparison to the business judgment rule the *Unocal* standard permits a court to examine more closely a board's actions in responding to an unsolicited offer, the Delaware Supreme Court's reversal of the Chancery Court's injunction in *Unitrin, Inc.* v. *American Gen. Corp.,* 651 A.2d 1361 (Del. 1995), reaffirmed Delaware case law granting a board reasonable latitude in this context. *See* Section B.2.

The Delaware Chancery Court recently reaffirmed the limited application of *Unocal* in the context of a board's refusal to engage in a merger transaction. In *Kahn* v. *MSB Bancorp, Inc.*, C.A. No. 14712-NC, 1998 Del. Ch. LEXIS 112 (July 16, 1998), the Chancery Court declined to apply the *Unocal*

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[3] Two subsequent Delaware Supreme Court decisions confirm that board actions subject to review under *Unocal* in the context of an active takeover defense will in other circumstances need to satisfy only the standard business judgment analysis. In *Williams* v. *Geier*, 671 A.2d 1368, 1377 (Del. 1996), the Delaware Supreme Court reiterated that adoption of a defensive measure approved by shareholder vote would not be subjected to *Unocal* scrutiny since it would not constitute a unilateral board action. In *Kahn* v. *Roberts*, 679 A.2d 460 (Del. 1996), the Delaware Supreme Court refused to apply *Unocal*'s enhanced scrutiny to a share repurchase program, because that program was not initiated in response to any perceived threat.

standard to the board's attempt to complete a strategic acquisition and its subsequent refusal to accept merger proposals from other parties. Since the board's contemplated acquisition was not a defensive response to the unsolicited merger offers, and in view of Delaware law (8 Del. Code Ann. § 251) which vests authority to enter into a merger with another company in the board, the court reasoned that the enhanced *Unocal* standard was not applicable. In dismissing the plaintiffs' claims, the court noted that the MSB Bancorp board was well-informed regarding the proposed mergers (including consultation with legal and financial advisors) and had a documented record of pursuing its long-term strategy of growth through selected acquisitions.

Transactions involving a sale of control of the corporation will also be subject to enhanced judicial review. The Delaware Supreme Court has defined directors' duty in the sale of control context as achieving the highest value reasonably available for stockholders. *Revlon,* 506 A.2d at 182. In *Revlon*, the court found that, once the directors had decided to sell control of the company, "[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *Id.* The court will require a reasonable decision, but not a perfect decision, in this regard. *QVC,* 637 A.2d at 45. The *Revlon* test, although defining a different responsibility than that of *Unocal*, has been construed as imposing essentially the same enhanced duties on directors as *Unocal* imposes. *See, e.g., Mills Acquisition Co.* v. *Macmillan, Inc.,* 559 A.2d 1261, 1287-88 (Del. 1989).

3. Entire Fairness

When an actual conflict of interest that affects a majority of the directors approving a transaction is found, Delaware courts apply the most exacting standard, "entire fairness" review, which requires a judicial determination of whether the transaction is entirely fair to stockholders. *See, e.g., Weinberger* v. *UOP, Inc.,* 457 A.2d 701 (Del. 1983). Such conflicts may arise in situations where the directors appear on both sides of a transaction, as in a management buyout, or derive a personal financial benefit that does not devolve

generally upon the corporation and its stockholders. *See, e.g., Ivanhoe Partners,* 535 A.2d 1334.

When analyzing a transaction to determine whether it satisfies the entire fairness standard, a Delaware court will consider both process – "fair dealing" – and price – "fair price" – although the inquiry is not bifurcated. *Weinberger*, 457 A.2d at 711. *Accord*, *Kahn* v. *Lynch Communication Sys., Inc.,* 638 A.2d 1110, 1115 (Del. 1994) (quoting *Weinberger*). In *Technicolor,* Chancellor Allen formulated the issue as follows: "Thus in assessing overall fairness (or entire fairness) in this instance the court must consider the process itself that the board followed, the quality of the result it achieved and the quality of the disclosures made to the shareholders to allow them to exercise such choice as the circumstances could provide." *Technicolor,* 663 A.2d at 1140.

In evaluating the process followed by the board, Chancellor Allen began by finding that a majority of the directors were disinterested and acted in good faith. In making this finding the Chancellor relied on the fact that expert legal counsel had advised the board that if in their business judgment they believed that the price was fair, they could authorize the sale without shopping the company. Further, Chancellor Allen found that (1) the chief executive officer of Technicolor was the principal negotiator and sought the highest price the buyer would pay, (2) the chief executive officer was experienced and knowledgeable, (3) the chief executive officer and the board were advised by leading investment banking and legal firms, (4) the price negotiated was about 100% more than the unaffected market price and the premium was higher than in comparable deals, (5) there was no indication that a higher price was available from anyone, (6) management refused to do a leveraged buyout at a higher price, and (7) the chief executive officer was a major shareholder and sold his shares to the buyer at the same price paid to the other shareholders.

In light of these factors, Chancellor Allen decided that the entire fairness test had been satisfied. In this respect, the Chancellor provided a useful definition of "fair price":

> A fair price does not mean the highest price financeable or the highest price that fiduciary could afford to pay.

> At least in the non-self-dealing context, it means a price that is one that a reasonable seller, under all the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept.

Id. at 1143. The Delaware Supreme Court in 1995 affirmed Chancellor Allen's *Technicolor* opinion. 663 A.2d 1156 (Del. 1995) ("A finding of perfection is not a *sine qua non* in an entire fairness analysis. That is because the entire fairness standard is not even applied unless the presumption of the business judgment rule has been rebutted by evidence that the [directors breached any one of their fiduciary duties]." *Id.* at 1179.) The Delaware Supreme Court's affirmance of no director liability in the context of entire fairness review of director conduct indicates that the absence of certain elements of fair dealing does not preclude the directors from establishing that the challenged transaction was otherwise fair, in terms of price and process, to stockholders.

A special committee of disinterested directors is often used as a means of satisfying the "fair-dealing" prong of the entire fairness test. The recent decision by the Delaware Supreme Court in *Kahn* v. *Tremont Corp.*, 694 A.2d 422 (Del. 1997) demonstrates the importance of insuring that the special committee operates in the manner necessary to shift the burden of proving unfairness to the plaintiffs. Tremont, a corporation controlled by Valhi, Inc., purchased 7.8 million shares of common stock of NL Industries, Inc. from Valhi. Valhi was 90% owned by a trust for the Harold C. Simmons family. The plaintiffs claimed that Simmons controlled each company and structured the purchase of NL shares to benefit Valhi at the expense of Tremont. The Court of Chancery reviewed the transaction under the entire fairness standard but held that Tremont's utilization of a special committee of disinterested directors to negotiate the transaction on behalf of Tremont shifted the burden of proving unfairness to the plaintiffs. With the burden of proof so shifted, the court concluded that both the price and the process were fair to Tremont.

On appeal, the Delaware Supreme Court agreed with the Court of Chancery that entire fairness is the proper standard of review and that a properly-functioning special committee of independent directors can shift the burden of proving unfairness

to the plaintiff. The court found, however, that three members of the Tremont special committee had previous affiliations with Simmons and received financial compensation or influential positions from Simmons. The court also found that two of the three members of the special committee did not take an active role in the bargaining process, leaving the member of the special committee most involved with Simmons to conduct all negotiations. The Delaware Supreme Court remanded the case for a redetermination of entire fairness with the burden of proof on the defendants.

* * *

Evolving Application of Standards. That directors' actions in connection with a transaction may initially be subject to one standard of review does not mean that their future actions in connection with that same transaction will necessarily be subject to the same level of judicial scrutiny. For example, the approval of a friendly stock-for-stock merger may invoke the traditional business judgment rule but modifications of that transaction after the appearance of a third party hostile bidder may be subject to the *Unocal* standard. *Compare Gilbert* v. *El Paso Co.,* 575 A.2d 1131, 1143-44 (Del. 1990) (because all of the board's actions were in response to an unsolicited tender offer seeking control of company, *Unocal* standard applied throughout) *with In re Santa Fe Pacific Corp. Shareholder Litig.,* C.A. No. 13587, 1995 Del. Ch. LEXIS 70, at *27 n.7 (May 31, 1995) (board's decision to enter into original stock-for-stock merger subject to business judgment review, but altered transaction in response to unsolicited third-party offer subject to enhanced scrutiny under *Unocal*), *aff'd in part*, *rev'd in part*, *both on other grounds*, 669 A.2d 59 (Del. 1995); *Time,* 571 A.2d at 1150-51, 1151 n.14 (original plan of merger entered into as part of corporate strategy subject to business judgment rule, while later actions in response to hostile tender offer are subject to enhanced *Unocal* standard).

B. Significant Cases

1. Stock Mergers, *QVC, Time* and *Society for Savings*

The basic principles discussed in Section A were applied to a change in control transaction in the Delaware Supreme Court's 1994 decision in the *QVC* case, which forms a bookend of sorts with the earlier application of these principles to a stock-for-stock merger in the 1989 takeover battle involving Time, Inc., *Paramount Communications Inc.* v. *Time, Inc.,* 571 A.2d 1140 (Del. 1989) ("*Time*"). *QVC* continues to be an important statement by the Delaware Supreme Court of a board's obligations in, and the applicability of *Revlon* to, stock-for-stock transactions.

It is important to note, first, what the *QVC* decision did not do. *QVC* limited its holding to the circumstances of a stock-for-stock merger involving a clear sale of control, where the resulting entity would have a single stockholder with approximately 70% of the combined voting power. The holding in *QVC* did not change the basic obligations of directors not engaging in a sale of control and it did not heighten judicial scrutiny of directors who are engaged in a sale of control.

Because most stock-for-stock mergers will not involve an acquiror having a stockholder or stockholder group with post-merger controlling voting power, they generally will continue to be evaluated under the well-established traditional business judgment rule, and directors approving such a transaction will not be subject to enhanced judicial scrutiny. Both *QVC* and *Time* verify that a stock-for-stock merger between two truly public companies will not constitute a change of control under Delaware law and, thus, will not trigger the requirement under *Revlon* that the seller's board seek, through auction or otherwise, the highest value reasonably available to stockholders. The doctrinal explanation for this application of the business judgment rule is that most stock-for-stock combinations simply shift "control" of the seller from one unaffiliated group of public stockholders to another such group, *i.e.,* the larger post-merger combined group of public stockholders of seller and acquiror. In such situations, there is no change in control even though the stockholders of one

company as a group may own less than a majority of the equity of the combined company.

QVC and *Time* make clear that a stock-for-stock merger in which no one stockholder, or affiliated group of stockholders, controls the post-merger voting power does not constitute a change of control under Delaware law and, thus, does not implicate *Revlon* duties. This principle was confirmed in the Delaware Supreme Court's December 1994 decision in *Society for Savings* where the court rejected a stockholder challenge to a common stock bank merger in a case that the court considered to be controlled by its decision in *QVC*. *Arnold* v. *Society for Sav. Bancorp, Inc.,* 650 A.2d 1270 (Del. 1994); *accord*, *Wells Fargo & Co.* v. *First Interstate Bancorp*, C.A. No. 14696, 1996 Del. Ch. LEXIS 3 (Jan. 18, 1996). The Delaware Supreme Court noted that there is no change in control when control remains "in a large, fluid, changeable and changing market" (quoting *QVC,* in turn quoting Chancellor Allen's opinion in *Time*). *Id.* at 1290. The Delaware Supreme Court rejected the argument that a change in control occurs when the company's stockholders are relegated to a minority position in the post-merger combined company. The court likewise rejected arguments that *Revlon* could be implicated without a change in control in the absence of an active bidding or auction process initiated by the company or on the basis of the directors' "subjective intent."

As a practical matter, however, directors of companies proposing to engage in a stock-for-stock merger must be cognizant of the possibility that if a hostile suitor offering greater current value appears following announcement of the merger, obtaining stockholder approval for the merger may well be problematic. In addition, under such circumstances, any actions subsequently taken by the board to defeat the hostile suitor will be judged by the enhanced *Unocal* standard.

In a stock-for-stock combination that does result in a change of control (because the buyer's controlling stockholder will continue in control of the merged entity) or in the case of a cash transaction, *Revlon* duties will arise. In such cases, if the board seeks to assert that the merger, although inferior in terms of current value, is superior to a higher competing bid in view of long-term strategic and business considerations, *QVC* has

much to say. *QVC* holds that long-term strategic and business concerns are irrelevant where the future strategy and synergies essentially will be out of the seller's stockholders' control and will reside principally in one individual or affiliated stockholder group. Indeed, *QVC* states that in *Revlon* circumstances, the board should value the stock consideration, not based on the expectation of future value enhancement, but as of the time it will be received by the seller's stockholders. *QVC,* 637 A.2d at 44 n.14.

QVC leaves open several significant issues. Most fundamentally, there may be circumstances in which it will be unclear whether there has been a change of control for *QVC* purposes. The *QVC* court's finding that the "proposed change of control" was "crystal clear" (and thus that the *Revlon* duties to obtain the best value reasonably available to the stockholders applied) is premised primarily on the fact that, after the Viacom-Paramount merger, a single individual would control a majority (in this case, 70%) of the voting power in the combined entity. 637 A.2d at 51. The court tied this fact to three concerns that underlie the enhanced scrutiny: the threatened diminution of current stockholders' voting power, the fact that the transaction involved the sale of an asset belonging to stockholders (a control premium) that might not be available again, and the traditional concern of Delaware courts for actions that impair or impede stockholder voting rights. *Id.* The decision also states that "[i]n other cases" the existence of a change of control transaction that triggers these duties "may be less clear." *Id.*

Indeed there are a number of "less clear" scenarios that fall between the one pole of a sale to an evident controlling stockholder (or a buyout for cash) and the other pole of a straight stock-for-stock merger in which the stockholders of each entity receive (or retain) voting stock in a non-controlled public company. For example, the seller's stockholders may receive nonvoting stock in the new entity, allowing them to retain an ongoing equity interest in the merged entity. Other provisions, such as continuing directors designated by the seller, could provide some protection for the selling stockholders' interests. *See Gilbert*, 575 A.2d at 1146. Whether consideration in the form of nonvoting securities will trigger *Revlon* duties has not yet been addressed by the Delaware courts.

In addition, *QVC* does not resolve various permutations of the control shareholder situation evident in that case. For example, suppose the resulting entity in a proposed stock-for-stock merger would not have a majority stockholder or affiliated group, but would have a 30%, 40% or 49.9% stockholder. Other than the line of majority stockholder, there is no bright line on this sliding scale of control. *See also Society for Sav.,* 650 A.2d at 1290. Yet it is hard to find a doctrinal justification, apart from ease of application, for a rule that would find that the *QVC* obligations apply in a stock-for-stock merger in which the resulting entity would have a 50.1% stockholder but not when the resulting entity would have a 49.9% stockholder (absent other circumstances such as a long-term standstill agreement governing the 49.9% stockholder, *see Ivanhoe Partners,* 535 A.2d 1334).

If the bright line of majority control is abandoned, there may be nothing to replace it other than a "facts and circumstances" standard. In this regard, the *QVC* court's characterization of a control premium as a corporate asset may provide more helpful guidance than its concern over the threatened diminution of the current stockholders' voting power. The voting power of a company's stockholders may easily be viewed as diminished or impaired by a stock-for-stock merger in which the resulting entity has any stockholder or group holding a major block of stock. On the other hand, the concern over whether the stockholders' opportunity to receive a control premium has been foreclosed will only be justified when the privately-held block is large enough effectively to bar a third-party bid for the combined company in the future, or to ensure that the normally attendant control premium goes to the holders of the private block to the exclusion of the other stockholders. Whether either the voting power or control premium concern is implicated by a stockholder or stockholder group owning less than a majority of the stock would require consideration of the capital structure and the allocation of voting power among large and small (and perhaps even active and passive) stockholders, matters that may not be susceptible of ready judicial resolution.

The Delaware Chancery Court has declined to apply the *Revlon* obligation in the context of a cash tender offer for 33% of the shares of Santa Fe Pacific Corp. to be followed by a

stock-for-stock merger with Burlington Northern, Inc. *In re Santa Fe Pacific Corp.*, C.A. No. 13587, 1995 Del. Ch. LEXIS 70 (May 31, 1995), *aff'd in part and rev'd in part*, 669 A.2d 59 (Del. 1995).

The line between a sale of the company (a change in control – *i.e., QVC*) and the execution of a business strategy that contemplates an ongoing enterprise after a merger (a strategic business decision – *i.e., Time*) remains somewhat blurred. At least where stockholders of the seller will become minority holders in the merged entity which will be controlled by a single stockholder or a controlling group of stockholders, *QVC* mandates that a board fulfill the *Revlon* best-value duty. Once *Revlon* is triggered, the various factors a board may consider in responding to competing bids and the measure of value the board may apply in assessing the "best" bid are narrowed. The sole criterion becomes seeking the most value for stockholders. *Revlon,* 506 A.2d at 182. As discussed in Section II C, the board's *Revlon* duty is itself complex when stock is part or all of the consideration.

2. Enhanced Scrutiny: *Unitrin*

The Delaware litigation concerning Unitrin, Inc.'s defensive responses to American General Corporation's all-cash hostile takeover offer in 1994 reaffirmed the power of directors to take reasonable steps to resist hostile bids. Whether a particular defensive device will survive the *Unocal* inquiry depends on the nature of the threat and the other means with which a board may fend off that threat. The Delaware Supreme Court decision in *Unitrin* illustrates the proportionality concern inherent in the *Unocal* analysis.

In *In re Unitrin, Inc. Shareholders Litig.,* C.A. No. 13656, 1994 Del. Ch. LEXIS 187 (Oct. 13, 1994), *rev'd and remanded*, 651 A.2d 1361 (Del. 1995), the Delaware Chancery Court preliminarily enjoined a proposed buyback of ten million shares at the then-current market price but did not enjoin the board's adoption of a shareholder rights plan. The court viewed the first portion of *Unocal,* whether a threat to corporate policy exists, as satisfied based on the board's conclusion that the offered price was inadequate, although it considered the threat from American General's publicly-

announced all-cash offer "a mild one."[4] The court enjoined the repurchase program based on the proportionality standard of *Unocal.* The court found that, because the repurchase program would raise the Unitrin board's stock ownership from 23% to 28%, it would chill proxy contests, and that this effect was not proportionate under *Unocal* because other Unitrin defenses, especially the rights plan, protected Unitrin shareholders from a coercive or inadequate offer. The court thus read *Unocal* to authorize judicial inquiry into whether a specific defensive step is "necessary."

In a sweeping rejection of the Chancery Court's reasoning, the Delaware Supreme Court held that Chancery's reading of *Unocal* placed too heavy a burden on the directors to justify defensive conduct. *Unitrin*, 651 A.2d 1361. The Supreme Court ruled that, in applying *Unocal,* a court should engage in a two-step process: first, the court should determine whether the defensive steps were "coercive or preclusive"; second, if the defensive steps were not "coercive or preclusive," then the court should determine whether the defensive conduct falls within a "range of reasonableness." If there is no coercion or preclusion, and the conduct is within the "range of reasonableness," the defensive action will be upheld:

> An examination of the cases applying *Unocal* reveals a direct correlation between findings of proportionality or disproportionality and the judicial determination of whether a defensive response was draconian because it was either coercive or preclusive in character.

Id. at 1387.

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[4] The Unitrin board also claimed that American General's offer created a risk of an antitrust violation. The court preliminarily rejected the theory of an "antitrust threat" as relevant to the first part of the *Unocal* analysis, stating that either the Federal Trade Commission would block the transaction (in which case no defensive device is necessary) or it would not (in which case there is no antitrust threat). *Id.* at 465-66.

> If a defensive measure is not draconian, however, because it is not either coercive or preclusive, the *Unocal* proportionality test requires the focus of enhanced judicial scrutiny to shift to "the range of reasonableness." Proper and proportionate defensive responses are intended and permitted to thwart perceived threats. When a corporation is not for sale, the board of directors is the defender of the metaphorical medieval corporate bastion and the protector of the corporation's shareholders. . . . [D]epending upon the circumstances, the board may respond to a reasonably perceived threat by adopting individually or sometimes in combination: advance notice by-laws, supermajority voting provisions, shareholder rights plans, repurchase programs, etc.

Id. at 1387-88, 1388 n.38 (citations omitted).

The Delaware Supreme Court accordingly directed the Chancery Court on remand to make a factual determination whether the Unitrin repurchase program "would only inhibit American General's ability to wage a proxy fight and institute a merger or whether it was, in fact, preclusive." *Id.* at 1388. (On this issue, the Supreme Court itself found that a proxy contest would remain viable, noting that "[t]he key variable in a proxy contest would be the merit of American General's issues, not the size of its stockholdings." *Id.* at 1383.) If the repurchase program does not doom any American General proxy fight to failure, the Supreme Court held that only one question will remain: "whether the Repurchase Program was within a range of reasonableness." *Id.* at 1389. The court then mapped out the factors that the Chancery Court should address on that subject:

> In considering whether the Repurchase Program was within a range of reasonableness the Court of Chancery should take into consideration whether: (1) it is a statutorily authorized form of business decision which a board of directors may routinely make in a non-takeover context; (2) as a defensive response to American General's Offer it was limited and corresponded in degree or magnitude to the degree or magnitude of the threat (*i.e.,* assuming the threat was relatively "mild",

> was the response relatively "mild?"); (3) with the Repurchase Program, the Unitrin Board properly recognized that all shareholders are not alike, and provided immediate liquidity to those shareholders who wanted it.

Id. *Unitrin* reaffirms the board's discretion to act within a range of reasonably proportional responses to unsolicited offers and rejects judicial identification of the "necessary" actions in this context. The Delaware Chancery Court's decision in *In re Santa Fe Pacific Corp.*, 1995 Del. Ch. LEXIS at *26-34, concluding that the adoption of a "discriminatory" rights plan to defend against a third-party unsolicited, all-cash all-shares offer was a reasonable measure under *Unocal* (though that conclusion was reversed on procedural grounds, 669 A.2d 59, 71-72 (Del. 1995)), again recognizes the board's discretion in preserving a strategic plan.

C. The Importance of Informed, Good-Faith Decisionmaking

Whether directors are in the realm of enhanced scrutiny or entitled to the traditional business judgment standard in connection with their decision to enter into a business combination or restructuring transaction, directors who act without adequate information or without active involvement in the decision to approve a merger will have difficulty defending the transaction in court. Although many of the cases discussed below involve changes in control, directors seeking to avoid liability for their actions or to preserve a transaction in the face of competing bids are well-advised to assume an active role in the decision process and to remain fully informed throughout that process. *See Time,* 571 A.2d at 1153-54. Failure to do so may enable a plaintiff to rebut the presumption inherent in the traditional business judgment rule and win a duty of care claim in cases where the traditional business judgment rule would otherwise have been applicable. Similarly, failure to assume an active role and remain fully informed may prevent the directors from sustaining their burden of proof in cases where an enhanced scrutiny standard is applicable.

In *QVC*, the Delaware Supreme Court emphasized the well-established principle that a board that fails to participate

actively in the decision to sell the company and rejects or accepts a proposed transaction without adequate information may not claim the protections of the business judgment rule. In *QVC*, the court found that the board breached its fiduciary duties by choosing to remain uninformed of the terms and conditions of a competing tender offer and second-step stock merger. The court cited with approval the prior Delaware case law regarding the duties of care and loyalty owed by directors to stockholders. *Cf. Unitrin*, 1994 Del. Ch. LEXIS 187, at *22 (court "troubled by the manner in which the board investigated American General's offer"), *rev'd, Unitrin,* 651 A.2d 1361 (Del. 1995).

The board should carefully document the basis for its decisions, because a central inquiry is whether the board acted on an informed basis. The *Time* court, albeit in the context of a *Unocal* standard, discussed at length the extensive participation of Time's board in the decision whether to seek a merger partner, the identification of important factors to be considered in evaluating any potential merger and the initial decision to seek a merger with Warner, as well as the board's active involvement after Paramount first appeared with a competing bid. *Time,* 571 A.2d at 1143-46. In finding the first prong of *Unocal* satisfied, the *Time* court also noted that "[t]he evidence supporting this finding [that Time was not inadequately informed as to Paramount's bid when it failed to negotiate with Paramount] is materially enhanced by the fact that twelve of Time's sixteen board members were outside independent directors." *Id.* at 1154. Although the *Time* court ultimately accorded great deference to the board's decisions, it did so only after extended discussion of the board's active engagement throughout the process. Accordingly, the importance of informed, independent board decisionmaking cannot be overstated. *See also MSB Bancorp*, 1998 Del. Ch. LEXIS 112, at *9-11.

Nothing in *QVC* changes the prior law that the directors' duty to inform themselves does not require them to open negotiations with an undesired suitor in the absence of circumstances that call into play the *Revlon* best-value duty. In *QVC,* and, most pointedly, in its initial order of affirmance of December 9, 1993, the Delaware Supreme Court held that the obligations of the Paramount directors included the duties "to

summon, and act with due care on, all material information reasonably available, including information necessary to compare the two offers to determine which of these transactions, or an alternative course of action, would provide the best value available to the stockholders" and "to negotiate actively and in good faith with both Viacom and QVC to that end." *Paramount Communications, Inc.* v. *QVC Network, Inc.,* C.A. Nos. 427, 1993, 428, 1993 (Consolidated), 1993 Del. LEXIS 440, at *7-8 (Dec. 9, 1993); 637 A.2d at 48. The statement that the directors' duties include a duty to negotiate should be understood in context as limited to circumstances where the directors themselves had already committed to a change of control transaction with Viacom.

D. Fiduciary Duties and Third-Party Bids

Entry into a merger agreement may give rise to an unsolicited competing cash bid by a third party. Since the third-party bid would represent a threatened change in control, the target's directors' actions with respect to that bid, including any changes to the original merger agreement, will be governed by the enhanced scrutiny *Unocal* standard. The Delaware Supreme Court's *Time* decision makes perfectly clear, however, that so long as the initial merger agreement does not itself involve a change in control transaction, the appearance of an unsolicited bid (whether cash or stock) does not in and of itself impose *Revlon* duties on the target of the bid. Rather, the seller, as a matter of law, is free to continue to pursue the original proposed merger assuming it has satisfied the applicable standard. Thus, as the court said in *Time:* "Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy." *Time,* 571 A.2d at 1154. *Accord, In re Santa Fe Pacific Corp.*, 1995 Del. Ch. LEXIS 70, at *23-26 (although a "bidding contest" did occur, *Revlon* duties not triggered where board did not initiate bidding and sought strategic stock-for-stock merger), *aff'd in part, rev'd on other grounds*, 669 A.2d 59 (Del. 1995). Absent the limited circumstances defined in *Revlon* (and *QVC*), a board is not obligated to choose short-term over long-term value and, likewise, "is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover." *Time*, 571, A.2d at 1150. *See also id.* at 1154 ("The fiduciary

duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals.”). *Accord, Society for Sav.,* 650 A.2d at 1289- 90.

Thus, even if the hostile bid provides greater current and other short-term value than the merger, and even if that hostile bid provides for an admittedly fair price, the target’s board may attempt to preserve or achieve for its stockholders the business benefits of the original merger transaction so long as the merger does not itself constitute a change in control.

In these circumstances, the directors’ conduct will be evaluated under the *Unocal* standard. In applying the first part (that there must be a threat to “corporate policy or effectiveness”) of the *Unocal* test to Time’s actions to preserve its merger with Warner Communications following Paramount’s bid, the court in *Time* held as follows:

> From [certain prior] decisions by our Court of Chancery, [plaintiffs] extrapolate a rule of law that an all-cash, all-shares offer with values reasonably in the range of acceptable price cannot pose any objective threat to a corporation or its shareholders. Thus, Paramount would have us hold that only if the value of Paramount’s offer were determined to be clearly inferior to the value created by management’s plan to merge with Warner could the offer be viewed — objectively — as a threat. . . .
>
> We disapprove of such a narrow and rigid construction of *Unocal*, for the reasons which follow.
>
> Plaintiffs’ position represents a fundamental misconception of our standard of review under *Unocal* principally because it would involve the court in substituting its judgment as to what is a “better” deal for that of a corporation’s board of directors. To the extent that the Court of Chancery has recently done so in certain of its opinions, we hereby reject such an approach as not in keeping with a proper *Unocal* analysis. *See, e.g., Interco,* 551 A.2d 787, and its progeny; *but see TW Services, Inc.* v. *SWT Acquisition*

> *Corp.,* Del. Ch. C.A. No. 10427, Allen, C. 1989 WL 20290 (March 2, 1989).

Time, 571 A.2d at 1152-53. The *Time* opinion gives directors great latitude in determining when a threat to a pre-conceived merger exists by stating that the first prong of *Unocal* does not contemplate a "mechanistic" comparison of the relative economic merits of the target board's long-term plan and the takeover bid. Most importantly, the above passage indicates that it is not for the court to determine whether a threat exists, but rather that the board of directors is free to make the determination – so long as it acts in good faith and after reasonable investigation.

The Delaware Supreme Court's opinion in *Time* characterizes the *Unocal* analysis as "open-ended" and states that the threats to corporate policy and effectiveness presented by the Paramount offer (and identified in good faith by an informed Time board) included (1) the "concern . . . that Time shareholders might elect to tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce"; (2) the question of whether the conditions attached to Paramount's offer introduced "a degree of uncertainty that skewed a comparative analysis"; and (3) the issue of whether the "timing of Paramount's offer to follow issuance of Time's proxy notice was . . . arguably designed to upset, if not confuse, the Time stockholders' vote." *Id.* at 1153. Similarly, in the *Unitrin* decision, the Supreme Court reaffirmed the range of concerns that a board properly may consider as a *Unocal* "threat," finding that the Unitrin board reasonably perceived a "risk of substantive coercion, *i.e.,* that Unitrin's shareholders might accept [the bidder's] inadequate Offer because of 'ignorance or mistaken belief' regarding the Board's assessment of the long-term value of Unitrin's stock." *Unitrin*, 651 A.2d at 1385.

E. The Duty to Auction

Because many mergers, in particular the typical stock-for-stock merger, do not invoke *Revlon* duties, there is no need to hold an auction or otherwise "shop" the company prior to entering into a merger agreement providing for such a transaction. Similarly, there is no need to make special

provision for a post-signing market check in the agreement for such a merger transaction. In this regard, however, it should be noted that, since the merger will require the affirmative vote of stockholders, there will be ample time for a competing transaction to be developed and presented to stockholders. The existence of such a transaction, if it provides current value sufficiently greater than that provided by the stock-for-stock merger, may make it impossible to achieve the requisite stockholder vote. *See Time,* 571 A.2d 1140.

Barkan, QVC and other cases make clear that, even when a board is subject to *Revlon* duties, no one mode of carrying out those duties is mandated, and that the board has reasonable latitude in determining the method of sale most likely to produce the highest value for the stockholders. Any method chosen, however, that does not involve a realistic market check will have a difficult time being sustained. *Barkan*, 567 A.2d 1279; *see also Kahn* v. *Caporella,* C.A. No. 13248, 1994 Del. Ch. LEXIS 29 (Mar. 10, 1994) (suggesting that the *Revlon/QVC* standard may not be met by market check where directors are not kept informed of inquiries; preliminary injunction as to "entire fairness" attack denied).

F. Investment Bankers' Fairness Opinions

In view of the complexity of valuing stock as consideration, an investment banker's fairness opinion will typically constitute an important element with respect to the board's deliberative process in any merger involving part- or all-stock consideration. Even in the case of an all-cash acquisition, however, the investment banker's view of the fairness of the consideration to be paid, and the related analyses, provide the board with significant information with which to evaluate a proposed transaction. In its evaluation of a business combination proposal, a board of directors is entitled to rely on the expert advice of the company's legal and financial advisors as well as on the advice and analyses of management. *See Technicolor,* 663 A.2d at 1142. The analyses and opinions presented to the board of directors, combined with presentations by management and the board's own long-term strategic reviews, provide the key foundation for the exercise of the directors' business judgment. Courts reviewing the actions of boards of directors have commented favorably on the use by

boards of directors of investment bankers in evaluating merger and related proposals. *See, e.g., Trans Union,* 488 A.2d at 876-77; *NCR Corp.* v. *American Telephone and Telegraph Co.,* 761 F. Supp. 475, 494 (S.D. Ohio 1991). *See also In re RJR Nabisco Shareholders Litig.,* [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194 (Del. Ch. 1989).

Particularly in change of control situations where the directors are obligated to choose among competing common stock (or other non-cash) business combinations, the board's decisionmaking may be susceptible to claims of bias, faulty judgment and inadequate investigation of the relative values of competing offers. Because the stock valuation process inherently involves greater exercise of judgment by the board, consideration of the informed analyses of financial advisors will be helpful in establishing the fulfillment of the applicable legal duties.

By making a detailed presentation to the board of the analyses underlying its opinion, the investment banker provides the directors with additional information against which the directors can apply their independent judgment. While there is no absolute duty that a board of directors obtain an investment banker's fairness opinion, the boards of virtually all target companies and many acquirors (at least with respect to major acquisitions) do so. In transactions requiring shareholder approval, fairness opinions are beneficial in supporting the recommendation of the board set forth in the proxy statement.

Extreme care should be exercised by investment bankers in preparing the analyses that support their opinions and in the presentation of such analyses to management and the board of directors. The wording of the fairness opinion and the related proxy statement disclosures must be carefully drafted to accurately reflect the nature of the analyses underlying the opinion and the assumptions and qualifications upon which it is based. Further, directors should carefully consider whether the restrictions they impose on the investment banker's conduct of the fairness evaluation (such as no market check) will result in an opinion that does not adequately support the board's analysis of competing stock mergers or that raises inferences of bias or conflict. In the Paramount contest, for example, Paramount management placed various limitations on the fairness diligence,

with the consequence that the fairness analysis and opinion did not protect the board's initial decision to reject QVC's hostile offer. Because the decision to prefer one change of control stock merger over another is inherently more subjective than choosing between two cash offers, the board may want to rely more heavily on a well-documented fairness opinion or on an opinion that expresses a quantitative (or qualitative) comparison of competing bids, such as the "financial superiority" opinions that Paramount's board received on several occasions from its financial advisor following the Delaware Supreme Court's *QVC* decision.

The SEC staff requires detailed disclosure of the procedures followed by the investment banker in preparing the fairness opinion, including a description of the constraints placed on the analysis by the board, as well as detailed disclosure of the banker "blue books" presented to the board. Sellers should assume that such disclosure will be required in the proxy and prospectus and should carefully consider the litigation consequences thereof.

Moreover, the issue of whether a fairness opinion should be "brought down" from the time of signing a merger agreement to the time of mailing the related proxy statement is a point to be considered by each party's board of directors. In a stock-for-stock merger, the "fairness" of the consideration often turns on the relative contributions of each party to the combined company – in terms of revenues, earning and assets – as opposed to the absolute dollar value of the stock being received by one party's stockholders. Parties to a stock-for-stock merger may opt to sign a merger agreement based on the fairness of the exchange ratio at the time of signing, without a "bring down." This structure may enhance the probability of consummation of the merger by not giving either party a right to walk away if the fairness opinion would otherwise have changed between signing and closing. In cases where the parties have negotiated an agreement without a bring down, the SEC staff has required detailed disclosure with respect to whether there have been any changes which would have affected the opinion had it been rendered as of a date closer to the mailing.

G. Good Corporate Governance and Fiduciary Duties

Good corporate governance policies and procedures are central to the directors' obligations in managing the affairs of the corporation, whether in the context of general oversight of the corporation or in the more intensified setting of a sale of the company or major acquisition. Decisions such as *Time* strongly suggest that a diligent, well-informed board of directors that is thorough in its deliberations will be credited with due exercise of good judgment, while cases such as *QVC* and *Lynch Communication* indicate that an ill-informed board that acts quickly and with limited consideration of the issues may have difficulty defending its conduct when challenged. Delaware Chief Justice Veasey has stated: "Directors have to ask hard questions, and seek and receive unvarnished advice. Both lawyers and directors should ask themselves if they can or should 'just say no' to management bent on a problematic course of action." Chief Justice E. Norman Veasey, Remarks to the Legal Advisory Committee of the New York Stock Exchange at 4 (Nov. 10, 1994).

There are many ways to implement good corporate governance policies. Critical aspects, such as the mix of independent and inside directors, should be established in writing and occasionally reviewed by the board. Some basic elements of good corporate governance include:

- the composition of the board of directors (number of outside directors; role the outside directors play in board deliberations and on important committees);
- the degree of independence of the independent directors (from the CEO in particular and from management generally);
- the board's knowledge of the subject matter, as demonstrated by distribution of materials for review in advance of meetings and the questioning of management and advisors during the board meeting;

- full disclosure by management of facts and circumstances relevant to the board's complete understanding of the decision it is making;
- the frequency and length of board meetings; and
- the quality of the advice provided by legal and financial advisors.

Institutional stockholders and shareholder activist groups continue to review closely the board's independence and to seek corporate governance reforms, including issues related to shareholder meetings and directors' compensation. *See e.g.*, CalPERS, *Corporate Governance Core Principles & Guidelines* (April 13, 1998). It is important that a board seek to establish appropriate governance policies prior to challenge from such stockholders, or from a hostile bidder who may be able to attract their support. *See also* M. Lipton & J. Lorsch, *A Modest Proposal for Improved Corporate Governance,* 48 Bus. Law. 59 (1992). A board seeking to establish the purpose and quality of its long-term strategy and desiring to remain independent even in the face of a hostile takeover will be well-served by careful attention to its corporate governance practices.

II

The Sale of the Company: Change in Control and Non-Control Transactions

As discussed above, the touchstone for judicial review in the context of a sale of the company is whether, after a stock-for-stock merger, a single stockholder or an affiliated group of stockholders will hold a majority of the post-merger voting power. (Of course, a cash sale will always result in a change of control for a widely held seller.) In the context of a non-control transaction, the actions of the board of directors in approving the transaction continue to be scrutinized under the traditional business judgment rule – *Revlon* duties do not apply. However, where the stock-for-stock combination does result in a change of control (because the buyer's controlling stockholder retains

control of the merged entity) or in the case of an all-cash transaction, *Revlon* duties do pertain. In these instances, long-term strategic and business concerns become irrelevant. The board's duty is to "secure the transaction offering the best value reasonably available for the stockholders." *QVC,* 637 A.2d at 44. Put another way, where *Revlon* duties are triggered, it is no longer permissible for a board, as it normally may, to "in effect, trade achievable current value for a prospect of greater future value." *Wells Fargo*, 1996 Del. Ch. LEXIS, at *13 (Jan. 18, 1996).

A disinterested board, however, maintains the right and continues to have the duty to exercise its business judgment in seeking to maximize shareholder value. *City Capital Assocs. Ltd. Partnership* v. *Interco, Inc.,* 551 A.2d 787, 802 (Del. Ch.), *appeal dismissed,* 556 A.2d 1070 (Del. 1988). Even in the change of control setting, the board may determine to enter into a merger agreement in an arm's-length negotiated transaction, as opposed to placing the company on the "auction block," if it in good faith determines that such a process is in the best interest of the company's shareholders. Moreover, even after a competitive bidding process has begun, a board may, under proper circumstances, favor one bidder over another "if in good faith and advisedly it believes shareholder interests would be thereby advanced." *In re Fort Howard Corp. Shareholders Litig.,* C.A. No. 9991, 1988 Del. Ch. LEXIS 110, at *41 (Aug. 8, 1988). In particular, courts have been willing to permit favoritism if it induces a new bidder to enter a bidding contest. Nevertheless, courts continue to scrutinize closely directors' conduct under the applicable standards of duty of loyalty and duty of care. Imperfections in the record or deviations from equal treatment of competing bidders, particularly once the decision to sell control of the company has been made, that cannot be supported on an articulable business basis, likely will lead a court to substitute its judgment for that of the board and to overturn the board's actions. *See QVC,* 637 A.2d at 50; *Macmillan,* 559 A.2d at 1282.

A. Fiduciary Duties in the Sale Context

1. *Revlon* Duties

A sale or change of control transaction imposes special obligations on the directors of a corporation. Most importantly, the directors must fulfill the basic *Revlon* directive: "The duty of the board . . . [is] the maximization of the company's value at a sale for the stockholders' benefit." *Revlon,* 506 A.2d at 182. Directors must exercise their fiduciary duties to further that end. This obligation has been consistently emphasized since the *Revlon* decision. *See Macmillan,* 559 A.2d at 1288 ("[I]n a sale of corporate control the responsibility of the directors is to get the highest value reasonably attainable for the shareholders."); *Barkan,* 567 A.2d at 1286 ("[T]he board must act . . . to encourage the highest possible price for shareholders."); *QVC,* 637 A.2d at 44 ("In the sale of control context, the directors must focus on one primary objective — to secure the transaction offering the best value reasonably available for the stockholders — and they must exercise their fiduciary duties to further that end.").

Barkan, QVC and other cases make clear that there is "no single blueprint" that directors must follow in selling a company. *Barkan,* 567 A.2d at 1286-87; *QVC,* 637 A.2d at 44. Rather, the board has reasonable latitude in determining the method of sale most likely to produce the highest value for the stockholders. Any method chosen, however, that does not involve some form of a realistic market check may be difficult to sustain. This Part reviews some of the methods by which a board can fulfill its duty to seek the best value reasonably available to stockholders.

2. Techniques for a Public Sale

a. Closed Auction

In a "closed" auction, prospective acquirors are asked to make a sealed bid for the company by a fixed deadline. The closed auction process is fairly straightforward. A company, usually with the assistance of an investment banker, may prepare a descriptive memorandum that is circulated to prospective bidders. Prior to the bidding, the company will

typically send a draft contract and related documentation to multiple parties. Interested bidders are allowed to engage in limited due diligence and then submit their bids, together with any comments on the draft contract. The closed auction often has more than one round and may involve simultaneous negotiations with more than one bidder.

A significant advantage of a closed auction is that it can be effective even if there is only one bidder. A bidder has no way to know whether there are other bidders and can be expected to put forward its best bid, particularly if the process is structured to involve only a single round. In addition, the seller in a closed auction can negotiate with the bidders to try to elicit higher bids. One disadvantage of the closed auction is that it may lead to suspicions among bidders that one bidder, such as a group affiliated with management, is favored over others, which may result in less participation or in later judicial actions scrutinizing the board's conduct in the auction.

b. Market Check

A second technique for selling a public company is the "market check." There are essentially two types of market checks. In a post-agreement market check, there generally is no auction of the company before a merger agreement is signed. Instead, a transaction is agreed to, subject to public announcement of the transaction and a fair opportunity for other bidders to make competing offers. The other form of market check occurs where, prior to signing an agreement, the company attempts to identify interested acquirors and the best price without initiating a formal closed auction. A pre-agreement market check may develop either where the company has attempted to attract bidders or other publicity has indicated that the company is seeking an acquiror or is the subject of an acquisition proposal (*i.e.*, or is "in play").

An advantage of a post-agreement market check is that it ensures that the target may secure the offer put forth by the first bidder while leaving the target open to pursue higher offers. Bidders, of course, will typically seek to limit the market check and will negotiate for bust-up and other fees in the event that the initial transaction is not consummated due to the emergence of another bidder. Further, some potential bidders

may be reluctant to compete with a transaction that has been publicly announced. Although a pre-agreement market check allows a potential seller to determine levels of interest and expected value without committing itself to a sale, as a practical matter a company engaged in such a process may be regarded as "on the block" and become the target of unsolicited (and unwanted) offers.

The effectiveness of a post-agreement market check depends on the ability of bidders to have a truly fair opportunity to make topping bids. A transaction that is truly locked up because of stock or asset options or proxies from large stockholders, or that is otherwise structured to deter third-party interest, may well have the effect those devices are intended to cause, and the market check will be of little value. *See, e.g., Technicolor,* 634 A.2d at 369. For a market check to be effective, bidders must be aware of the opportunity to bid, have sufficient information and time to make a bid, and not be deterred by breakup fees or lock-ups given to the first bidder. Although a market check has never been explicitly required by a Delaware court, it can allow the market to validate the board's decision to accept a buyout proposal and help establish the board's fulfillment of its *Revlon* duties. *See Barkan*, 567 A.2d at 1286-87.

3. The Business Judgment Rule and Selling the Company

In cases since *Revlon,* courts have recognized that a disinterested board of directors' decisions regarding how to sell control of the company are protected by the business judgment rule. In *Macmillan,* the court stated that "[i]n the absence of self-interest, and upon meeting the enhanced duty mandated by *Unocal,* the actions of an independent board of directors in designing and conducting a corporate auction are protected by the business judgment rule." *Macmillan,* 559 A.2d at 1287 (citations omitted). The court continued that "like any other business decision, the board has a duty in the design and conduct of an auction to act in 'the best interests of the corporation and its shareholders.'" *Id.* (citations omitted). The decision as to which process will produce the best value reasonably available to stockholders is, therefore, within the business judgment rubric, provided that the board or special

committee evaluating the proposed transaction is not affected by self-interest and is well-informed as to the process.

The courts have stressed that directors must pursue the sale of the company, particularly the maximization of shareholder value, with diligence. Whether a company holds an auction or negotiates a sale transaction, the board approving any sale of control must be fully informed throughout the process of the nature of the transaction and the other options available to it. That is not to say that a board must always seek out those other options. A recent Delaware case found that a board of directors did not violate its *Revlon* duties by not approaching a known interested party who might have offered more when that party had made a strategic decision not to deal with the target's board. *See Golden Cycle, LLC* v. *Allan*, C.A. No. 16301, 1998 Del. Ch. LEXIS 237 (Dec. 10, 1998). Ultimately, the process to be pursued irreducibly is a matter of judgment.

A principal difficulty in any auction process is that the true "value" of a bid, which must consider not only the price to be paid but also the likelihood of consummation and the related financing and regulatory approval risks, may be difficult to discern from a written proposal. A negotiated transaction will typically allow the seller to determine the nature of those risks before public announcement of a transaction.

It is important to note that, even in the change of control context, the board retains a good deal of authority to determine the best value reasonably available to stockholders. The difficulties that may arise in valuing stock and other consideration are discussed in Section II.C; the related board decisions require the exercise of informed judgment. In addition, other factors may lead a board to conclude that a particular offer, although "higher" in terms of price, is substantially less likely to be consummated. The directors "should analyze the entire situation and evaluate in a disciplined manner the consideration being offered. Where stock or other non-cash consideration is involved, the board should try to quantify its value, if feasible, to achieve an objective comparison of the alternatives." *QVC,* 637 A.2d at 44. The Delaware Supreme Court has stated that a board may assess a variety of additional practical considerations, including an offer's "fairness

and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; . . . the risk of nonconsummation; . . . the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on stockholder interests." *Macmillan,* 559 A.2d at 1282 n.29. In the context of two all-cash bids, a Delaware chancery court recently upheld the board's choice of a bid that was "fully financed, fully investigated and able to close" promptly over a nominally high yet more uncertain competing offer. *Golden Cycle,* at 38. Such concerns, however, must be evenly applied when evaluating competing bids for the sale of control. Financing conditions, for example, will typically be featured in any bid, although an informed board may properly conclude that one bidder is more likely to obtain financing than another.

4. Recent Delaware Statutory Amendments Relating to Merger Agreements

Effective July 1, 1998, Delaware implemented certain amendments to Section 251 of the Delaware General Corporation Law. The first change requires that a board of directors approving a merger agreement conclude that the merger agreement is "advisable" in the resolutions approving the merger agreement. 8 Del. Code Ann. § 251(b). The "advisable" determination mirrors the statutory requirement regarding board approval of charter amendments. *See* 8 Del. Code Ann. § 242(b)(1). This requirement is consistent with the Delaware case law regarding directors' duties of loyalty and care in connection with approval of extraordinary transactions.

The second change to the merger statute provides that a Delaware corporation may, in a merger agreement, provide that the agreement may be submitted to shareholders even if the board of directors, having deemed the merger agreement advisable prior to execution, subsequently changes its recommendation. 8 Del. Code Ann. § 251(c). This amendment clarifies dictum in certain Delaware cases that could be read to prohibit a board from submitting for shareholder approval a merger agreement no longer recommended by the board. A board that desires to include such a contractual provision must carefully consider whether, regardless of the nature of the changed circumstances, a merger agreement should be

submitted for shareholder approval over the disapproval (or neutrality) of the board.

B. The Use of Special Committees in Sale of Control Situations

When *Revlon* duties apply, the board's conduct will be evaluated by review of both its process and its result. As a consequence, a board engaging in a change of control transaction must establish basic procedures to preserve the integrity of its evaluation of the options that may arise. One critical element is to ensure that only disinterested directors evaluate and vote on the proposed transaction.

If the interested directors constitute a minority of the board, the disinterested majority can act for the board, with the interested members abstaining from both deliberations and the vote on the proposal. If a majority of the board is not disinterested, the board can delegate the power to review and negotiate the terms of the acquisition proposal to a committee of independent directors.[5] Even where a majority of the directors are independent, however, delegation of negotiating or review functions to a special committee may make practical sense.

Provided that the actions of the special committee satisfy the business judgment rule, the directors will avoid the burden of proving the "entire fairness" of the transaction. Instead, the burden will be placed on the party challenging the transaction. The case law, however, indicates that proper procedures must be followed by the special committee. In particular, "the special committee must have real bargaining power that it can exercise with the majority shareholder on an arm's length basis." *Rabkin* v. *Olin Corp.,* [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,255, at 96,164 (Del. Ch.), *aff'd,* 586 A.2d 1202 (Del. 1990), *accord, Kahn* v. *Dairy*

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[5] Although such delegation to a committee is proper under Delaware law, the entire board must approve the merger. *See* 8 Del. Code Ann. § 251(b).

Mart Convenience Stores, Inc., C.A. No. 12489, 1996 Del. Ch. LEXIS 38, at *21 (Mar. 29, 1996). The committee should receive independent financial and legal advice, negotiate diligently and without the influence of the controlling shareholder, and possess all relevant material information.[6] *Cf. Kahn* v. *Lynch Communication Sys., Inc.,* 638 A.2d 1110, 1118-21 (Del. 1994) (reversing trial court's finding that the independent committee acted at arm's-length in negotiation with controlling shareholder).

It is also important that the special committee have a clear conception of its role. In *In re Trans World Airlines, Inc. Shareholders Litig.,* C.A. No. 9844, 1988 Del. Ch. LEXIS 139 (Oct. 21, 1988), the court criticized the role of the special committee in reviewing a cash-out merger proposal. The court noted that the special committee relied almost exclusively on the efforts of its investment banker in evaluating the fairness of the price offered and negotiating the terms of the proposed transaction. The court found this problematic because "the directors did not seem to understand that their duty was to strive to negotiate the highest or best available transaction for the shareholders whom they undertook to represent." *Id.* at *12. The court also noted the passive role of the special committee in negotiating the terms of the proposed transaction. Similarly, in *Macmillan,* the Delaware Supreme Court criticized the special committee for neither taking reasonable steps to investigate whether a bidder considered by management to be hostile would increase its offer price nor attempting to negotiate

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[6] To avoid the burden of proving entire fairness, interested directors must inform a special committee of (1) material transaction terms; (2) material facts relating to the use or value of the assets in question, including "hidden value;" and (3) material facts relating to the value of the assets to third parties, such as forthcoming changes in technology or legal regulation. On the other hand, interested directors need not disclose the reservation price they have assigned to assets nor their plans regarding the use of sale proceeds. Such information, though material, is protected by a "negotiation privilege." *Kahn* v. *Tremont Corp.*, C.A. No. 12339, 1996 Del. Ch. LEXIS 40, at *53-55 (Mar. 21, 1996) *rev'd and remanded*, 694 A.2d 422 (Del. 1997).

improvements in management's competing bid. *Macmillan,* 559 A.2d at 1286. In general, the obligations of a special committee parallel those of the board engaged in a sale of the company.

More recently, in *Lynch Communication,* the Delaware Supreme Court suggested that even where a special committee obtains independent legal and financial advice and negotiates diligently, the requisite degree of independence may still be lacking if the committee and controlling stockholder fail to prove that the committee had the power to negotiate independently. An important aspect of an independent committee's understanding of its role is its appreciation of the power to say no. *Lynch Communication,* 638 A.2d at 1119. A board committee that does not recognize, even in the context of a takeover bid by a controlling shareholder, that it may refuse to accept the offer might bear the burden of proving the entire fairness of the transaction in court. *Id.* at 1117. In *Lynch Communication,* the court was persuaded that the committee's negotiations were influenced by the controlling shareholder's threat to acquire the company in a hostile takeover at a much lower price if the committee did not endorse the controlling shareholder's offer. On remand, the Court of Chancery found, and the Delaware Supreme Court affirmed, that the domination of the controlling shareholder did not upset the entire fairness of the transaction. *Kahn* v. *Lynch Communication Sys., Inc.,* C.A. No. 8748, 1995 Del. Ch. LEXIS 44 (Apr. 17, 1995), *aff'd,* 669 A.2d 79 (Del. 1995).

1. When Should a Special Committee Be Formed?

The function of the special committee is to protect shareholder interests in cases where the interests of management directors or other interested directors differ significantly from those of the shareholders. In considering whether directors are interested, it is important to determine whether, in fact, the interests of any directors are in conflict with those of the stockholders. In addition, the influence (and number) of the interested directors on the board may be relevant: a board consisting of strong independent directors may not be significantly affected by one management director promoting a leveraged buyout. In such a case, it may be

sufficient for the interested directors to recuse themselves from any deliberations and votes in connection with the proposed transaction. The independence of the company's legal and financial advisors must also be considered, since these advisors can influence the board's deliberations.

The need for a special committee may shift as a sale of control evolves. Acquirors that begin as third-party bidders may become affiliated with management, or management may respond to an unsolicited offer by organizing and proposing a management buyout. Throughout the sale process, the board and its advisors must be aware of any conflicts that may arise. Failure to disclose such conflicts may result in substantial difficulties in defending the board's actions in court. *See, e.g., Technicolor,* 634 A.2d 345.

2. Workings of the Special Committee

It is preferable that the committee, rather than management, choose its financial and legal advisors. In *Macmillan*, the Delaware Supreme Court was critical of the conduct of an auction to sell the company in which a financial advisor selected by the company's CEO, rather than by the special committee, played a dominant role. 559 A.2d at 1279-80.

Moreover, as indicated in the *Tremont* decision discussed in Section I.A.3, the selection of the members of a special committee is critical. Even if directors do not have a direct interest in the matter being reviewed, if they are viewed as "beholden" to a controlling shareholder or management, their service on a special committee will not serve to satisfy the entire fairness test.

The records of the committee's and the board's deliberations should reflect careful and informed consideration of the issues by the special committee and by the full board. Counsel can help frame the agenda, review in advance the nature of the oral and written reports that the financial advisors and others will render and review or assist in the preparation of appropriate minutes.

In assessing a bid, the special committee and its advisors may take into consideration the same factors that the board could consider in deciding which alternative offer for the company maximizes shareholder value.

C. Valuing Stock Consideration in Acquisition Proposals

The value of the consideration offered in a proposed transaction is clearly a significant element in the board's decision whether to reject or accept the offer. Even with diligence, the evaluation of a stock merger, regardless of whether it involves a sale of control, can be quite complex. Directors may properly weigh a number of issues in evaluating such a proposal.

1. Qualitative Factors: Short- and Long-Term Values

Although nominal current market value provides a ready first estimate of the value of a transaction to the company's stockholders, the Delaware Supreme Court in *QVC* and in other cases has stated that such valuation is inadequate and certainly not determinative of value. *See, e.g., Trans Union,* 488 A.2d at 875. In the sale of control context, the directors of the company have one primary objective: "to seek the transaction offering the best value reasonably available to the stockholders." *QVC,* 637 A.2d at 43. This objective would appear not to be satisfied by simple reliance on the latest closing prices on the relevant stock exchange: "[A] board of directors is not limited to considering only the amount of cash involved, and is not required to ignore totally its view of the future value of a strategic alliance . . . . When assessing the value of non-cash consideration, a board should focus on its value *as of the date it will be received by the stockholders.* Normally, such value will be determined with the assistance of experts using generally accepted methods of valuation." *Id.* at 44, 44 n.14 (emphasis added; citations omitted).

In *Trans Union,* a seminal Delaware Supreme Court decision on director responsibilities in selling a company, the court criticized the directors for relying upon the stock market prices of the company's stock in assessing value. The court

held that using stock market trading prices as a basis for measuring a premium "was a clearly faulty, indeed fallacious, premise." *Trans Union,* 488 A.2d at 876. Instead, the court emphasized that the key issue must be the intrinsic value of the business and that the value to be ascribed to a share interest in a business must reflect sound valuation information about the business. The same point was reiterated by the Delaware Supreme Court in its decision in *Time,* where the court pointedly noted "that it is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value." *Time,* 571 A.2d at 1150 n.12.

Directors may also consider historical trading averages and other financial indicators of future market performance. The result of such analyses may be that the board values one bidder's security with a lower current market value more highly than another security with a higher current trading value.[7] Of course, the seller's stockholders may not agree with the board in such a case and may reject an offer with a lower current market value.

Under either the *Revlon* standard or the traditional business judgment rule, the valuation task necessarily calls for the exercise of business judgment by the directors. The board must make sophisticated financial valuations and other qualitative judgments concerning the potential for success of the combined company. Extensive due diligence by both parties to a stock-based merger is an indispensable prerequisite to informed decisionmaking, as is detailed analysis of pro forma financial information and contribution analyses. Risk assessment is also an important factor since experience has

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[7] In the context of competing bids, market prices may be a particularly confusing indicator. Once the offers are announced, the market may discount the securities of the higher bidder to reflect a likely victory and the accompanying dilution, but it also may discount the securities of the lower bidder if that party is expected to raise its bid. These uncertainties, however, do not affect the validity of historical trading averages and other market comparisons which are not based on current stock prices.

shown there to be a significant risk of failure to achieve the expected benefits of the merger, which, in turn, may have a negative impact on stockholder values. The directors of a company may need to consider such factors as:

- *Past performance of the security being issued*
- *Management*
- *Cost savings and synergies*
- *Past record of successful integration in other mergers*
- *Franchise value*
- *Antitrust issues*
- *Earnings dilution*
- *Certainty of consummation*

While predicting future stock prices is always speculative, a board of directors can and should assess such factors, evaluate the long-term track record of the other party and test the business rationales that underlie a merger proposal as well as the future prospects for the combined companies. The exercise of judgment and the evaluation of fundamental business points are inescapable. To the extent competing bids are under review, directors should be careful to apply the same evaluation criteria in an unbiased manner, to avoid any suggestion that they have a conflict of interest or are not acting in good faith.

In making these strategic judgments, directors are not, absent a *Revlon* duty, obliged to restrict themselves to an immediate or other short-term time frame. The directors are entitled to select the transaction that they believe provides stockholders with the best long-term prospects for growth and value enhancement with the least amount of downside risk; the directors thus have a substantial range for the exercise of their judgment. In its *Time* decision, the Delaware Supreme Court stated that the directors' statutory mandate "includes a conferred authority to set a corporate course of action,

including time frame, designed to enhance corporate profitability." *Time,* 571 A.2d at 1150. In the same vein of judicial deference to director decisionmaking, the court in *Time* likewise ruled that a court should not be involved in "substituting its judgment as to what is a 'better' deal for that of a corporation's board of directors." *Id.* at 1153. *QVC* did not change these basic premises of director fiduciary duty outside the change in control context.

2. Other Constituencies

In stock mergers not involving a change in control, the directors may appropriately consider the effect of the transaction on non-stockholder constituencies. In seeking to achieve stockholder value, the directors should appropriately take into account the impact of the prospective transaction on the company, its employees, its customers and the community in which it operates. *E.g., Time,* 571 A.2d at 1150, 1152. Such constituencies are entitled to consideration at least on the basis that the realization of stockholder value is dependent in part upon them. Even where a board's action may be subject to enhanced scrutiny, Delaware case law has recognized the legitimacy, albeit more limited, of similar concerns. *See Unocal,* 493 A.2d 946; *Mills Acquisition Co.* v. *Macmillan, Inc.,* [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch.), *rev'd on other grounds,* 559 A.2d 1261 (Del. 1989).[8]

Proper consideration of employee and other constituent interests is also extremely important in assuring a smooth transition period between the signing of a merger agreement and the closing of the transaction. Mergers may require a lengthy time period for consummation; for example, many of the recent strategic mergers in industries such as banking and

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[8] In the *Macmillan* case, the Delaware Supreme Court noted that it was legitimate for a board to consider the "effect on the various constituencies" of a corporation, the companies' long-term strategic plans, and "any special factors bearing on stockholder and public interests" in reviewing merger offers. *Macmillan,* 559 A.2d at 1285 n.35.

telecommunications raise substantial regulatory and antitrust issues that must be resolved prior to consummation. Given the added risks of non-consummation inherent in equity deals, or in any transaction involving a regulated industry, it is important for the target company to strive to preserve franchise value throughout the interim period. Moreover, the impact of a proposed transaction on the target company franchise and local community interests can have a direct impact on the acquiror's ability to obtain the requisite regulatory approvals.

3. The Proper Role of Social Issues

In evaluating a merger or acquisition proposal, the economic terms of the proposal and the benefits that the proposal brings to shareholder interests will predominate in the directors' inquiry. Nevertheless, "social issues" – concerns for the community and the combination's impact on the continued viability of various operations – can play an important role in bringing two merger partners to the negotiating table and may be properly considered by directors in evaluating the strategic benefits of a potential merger or acquisition transaction not involving a change in control, at least insofar as they will promote future value.

III

Protecting the Deal

Because of the possibility of third-party bidders, parties to business combination transactions frequently request or insist on certain protections from, or compensation for, third-party interference, regardless of whether the other party to the business combination is subject to *Revlon* duties. Although cases such as *QVC* have challenged director conduct in this area, directors continue to have substantial means available to protect a preferred transaction, or to reject all offers and remain independent.

A. Stock Options and Break-Up Fees

Stock options on up to 19.9% of the target company's shares, including a put provision that has been standard in nearly all stock options granted in bank transactions over the past several years as well as in options granted in many other strategic mergers, may be appropriate as a means of inducing another party to make a merger proposal. Also commonly used are so-called termination, or "break-up," fees — ranging from 1% to 3% of the transaction value[9] — designed to compensate one party to a merger agreement if the merger is not consummated because a bid is made for the other party. Where options or break-up fee provisions are granted primarily as a defensive tactic to deter potential third-party bidders, like any other defensive device, they will be subject to enhanced scrutiny under *Unocal:* there must be reasonable grounds for the belief that there is a danger to corporate policy and the defensive measure must be reasonable in response to the perceived threat.

In the case of a stock-for-stock merger of equals, reciprocal stock options or break-up fees may be appropriate. In *Time,* each company had a 10% stock option on the other company's stock that would be triggered by third-party interference with the transaction. The Delaware Supreme Court noted approvingly that this feature of the agreement had the rational business purpose of protecting the stock merger agreement and was adopted to prevent either Time or Warner from being put into play as a result of their agreement. The court also noted that the option was adopted before any takeover threat from a third party had surfaced, and that the "no-shop" clause in the agreement was adopted at the insistence of the other party in arm's-length bargaining. *Time,* 571 A.2d at 1151 n.15.

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[9] A study of 169 transactions in 1997 in which termination fees were payable by the target to the acquirer found a mean and median termination fee as a percentage of transaction value of 2.7%. See Houlihan Lokey Howard & Zukin 1997 Transaction Termination Fee Study.

The *QVC* decision was highly critical of the stock option and bust-up fee arrangements that were entered into between Paramount and Viacom in the initial merger transaction. The features in the *QVC* lock-up option which drew the court's criticism included a cash put feature enabling Viacom to "put" the option to Paramount at the spread between the exercise price and Paramount's market price, a note feature permitting the option to be exercised for a Viacom subordinated note, and the open-ended value of the option. Notably, the criticism of the Paramount option was in the context of a change of control transaction – *i.e.*, the Viacom transaction always contemplated voting control of Paramount shifting to a single individual.

The Delaware Supreme Court did, however, make clear in *QVC* that stock option and bust-up fee arrangements are neither *per se* nor presumptively invalid. Indeed, the court cited other cases in which stock options were upheld.

More recently, in *Brazen* v. *Bell Atlantic Corporation*, 695 A.2d 43 (Del. 1997), the Delaware Supreme Court upheld a $550 million termination fee in the Bell Atlantic/NYNEX merger agreement. The Court of Chancery had upheld the provision, applying the business judgment rule. The Delaware Supreme Court found that the provision, which stated that it was a liquidated damages clause, should have been analyzed as such, but then upheld it on the grounds that it was reasonable because it was within the range of termination fees which have been upheld as reasonable by the Delaware courts.[10]

[10] Surveys of stock-for-stock transactions since January 1, 1994 where the value of the stock issued exceeded $1 billion demonstrate that termination fees typically fell within a range of 1% to 3% of such value but were as high as 5% on occasion. The 1998 Houlihan Lokey study, involving deals with an aggregate transaction value of at least $50 million, found that termination fees ranged from 0.6% to 6% of such value, with the median at 2.7%. Of further interest was the sliding scale of median termination fees depending upon deal size, with the smallest deals – between $50 million and $250 million – at 3% of transaction value and the largest transactions – over $1 billion – at 2%. *See id.*, at note 9.

Following the decision in *Bell Atlantic*, the Delaware Court of Chancery upheld the decision of the board of Great Western Financial to include a break-up fee in a "white knight" merger agreement entered into in response to an unsolicited $6 billion acquisition proposal by Ahmanson. *Ahmanson* v. *Great Western Financial Corporation*, C.A. No. 15650, 1997 Del. Ch. LEXIS 84 (June 3, 1997). The court ruled that the 3% break-up fee in a $7 billion white knight transaction did not raise significant issues of validity, even where half the fee was to be payable solely upon the loss of the shareholder vote to approve the merger.

In Newmont Mining's acquisition of Santa Fe Pacific Gold, the SEC's Office of the Chief Accountant, following extensive staff review, clarified its position on the impact of cash break-up fees on subsequent pooling-of-interests transactions. Homestake Mining had originally entered into a merger agreement with Santa Fe containing a $65 million cash break-up fee (approximately 3% of the aggregate deal value) payable in the event Santa Fe entered into a business combination transaction with a third party. Newmont Mining made a competing proposal for Santa Fe, conditioned upon the receipt of pooling-of-interests accounting treatment for its transaction. The SEC staff initially raised a question as to whether the break-up fee should be considered a significant disposition of assets that would prevent the Newmont transaction from qualifying for pooling treatment. The SEC's Office of the Chief Accountant ultimately accepted Newmont's position that a customary cash break-up fee negotiated on an arm's-length basis should not prevent pooling treatment for a subsequent successful intervening bidder.

B. Cash Put Provisions

As mentioned above, lock-up options granted in connection with acquisitions may include a so-called "cash put" provision providing that, in the event of a higher bid, the acquiror has the right to "put" the option back to the target at a per share price equal to the difference between the option exercise price and the higher bid. *QVC* does not regard these options as *per se* breaches of the directors' duties. Particularly in the case of bank acquisitions, the put right gives the option more bite because exercise of the put does not generally require

prior regulatory approval, provided that the amount of cash paid out on exercise of the put does not exceed 10% of the target's consolidated net worth. 12 C.F.R. § 225.4(b)(1). By contrast, exercise of an option to purchase in excess of 5% of the target's outstanding shares would be subject to prolonged regulatory review, which could result in the acquiror being deprived of the benefit of its bargain. The exercise of the put right can serve to both protect the initial transaction and provide the acquiror with a profit, should the initial transaction be outbid.

Moreover, the put also carries significant deterrent value. Under applicable accounting principles, the exercise of the put may inhibit pooling treatment for any competing offer. Because the availability of pooling treatment is often vital to a successful merger, stock option agreements are a particularly effective way of protecting a signed acquisition agreement.

A target will want to limit exercise of both the underlying option and the put to actual change of control events (that is, the consummation and not just the proposal of a competing offer) to avoid exposing the target to a third-party bid that allows the initial acquiror to exercise the put but is then never consummated, leaving the target with depleted capital and a long face. So-called "double triggers" have been developed that provide for certain "vesting" events (such as a publicly announced competing bid) that extend the life of the lock-up beyond the normal termination provisions, as well as for events giving rise to the right to exercise the option and the put.

C. "No-Shop" and "Window-Shop" Clauses

A "no-shop" provision in a merger agreement provides that, subject to limited exceptions (typically to comply with the directors' fiduciary duties), the target company will not encourage, seek, solicit, provide information to or negotiate with third-party bidders; a "window-shop" clause generally allows the seller to respond to unsolicited offers by supplying confidential information and to consider certain competing bids. For the same reasons discussed above, a reasonable no-shop or window-shop provision in a negotiated merger will be sustainable.

While a prohibition on the solicitation of other bidders may be reasonable, overly restrictive no-shops may be rejected by the court as not in the best interest of stockholders. In *QVC,* both the Delaware Supreme Court and the Court of Chancery expressed concern that the highly restrictive no-shop clause of the Viacom-Paramount merger agreement was interpreted by the Paramount board as preventing it from even learning of the terms and conditions of QVC's offer, which was initially higher than Viacom's by roughly $1.2 billion. The Delaware Supreme Court did not require negotiations with all comers, but it had difficulty seeing the justification for a stiff arm when it seemed obvious that the directors wished to impose ignorance on themselves as an excuse for inaction.

After *QVC,* a board in a sale of control situation must be careful not to contract away its ability to become informed as to the true value of the company and of all bids. Even outside the sale of control context, the *QVC* decision emphasizes the importance of reasonableness in such restrictions. A normal no-shop provision will prohibit a company from initiating discussion with third parties but will permit the company to provide and receive information in response to unsolicited third-party initiatives.

The inference to be drawn from recent case law is that extremes with respect to lock-ups, bust-up fees and no-shop clauses may jeopardize the transaction if litigation ensues. There are no *per se* rules, however, even where *Revlon* duties apply. Even stringent no-shops and large stock options can be justified if they are utilized under circumstances in which they "assist the board in their 'obligation to seek the best value reasonably available' for the stockholders." *Rand* v. *Western Air Lines, Inc.,* C.A. No. 8632, 1994 Del. Ch. LEXIS 26, at *19 (Feb. 25, 1994) (record showed no-shop provision and lock-up stock option were traded for a weakened "material adverse change" provision after full market canvass with only one viable merger partner remaining), *aff'd,* 659 A.2d 228 (Del. 1995).

D. Management/Shareholder Voting Lock-ups

In addition to stock options, no-shop clauses and bust-up fees, an acquiror may also seek commitments from

significant shareholders of the seller, whether members of management or otherwise, to support the transaction. Such voting lock-ups may be in the form of voting agreements or separate options for the acquiror on such individuals' stock. The visible, up-front support of major shareholders for a transaction can be a significant deterrent to third-party bids and may be critical in consummating the transaction. Viacom's merger with Blockbuster, for example, was approved after some delay by holders of 58% of Blockbuster's outstanding common stock, including management proxies comprising nearly 23% of the outstanding shares.

In court, however, these lock-ups in a change of control transaction will be scrutinized together with other protective and defensive measures to determine whether the board has fulfilled its *Revlon* duties. Stockholder options granted at the request of the board of the seller rather than the acquiror may be suspect because such arrangements can prevent or deter third-party bidders. Stockholder lock-ups obtained prior to or in conjunction with the board's approval of the merger agreements will be significant elements of a court's review of whether the board has fulfilled its fiduciary obligations, particularly under any heightened standard, since substantial lock-ups can effectively eliminate the possibility of a third-party bid. *See Technicolor,* 634 A.2d at 369 (acquiror's lock-up was one of five factors supporting conclusion that directors violated their duty of care in approving the transaction).

E. The Use of Protective Devices in Non-Control Transactions

QVC did not alter the law with regard to no-shops, bust-up fees, stock options and stockholder lock-ups in transactions not involving a sale of control. Those devices have long been recognized by Delaware courts as permissible means of protecting a transaction from third-party bids or as part of the bargaining to induce a preferred merger partner into an agreement. Such devices do not trigger *Revlon* duties but will be subject to a *Unocal* analysis. *See Time,* 571 A.2d at 1151. *Accord, In re Santa Fe Pacific Corp.,* C.A. No. 13587, 1995 Del. Ch. LEXIS 70, at *32 n.8 (May 31, 1995), *aff'd in part, rev'd in part, both on other grounds,* 669 A.2d 59 (Del. 1995). *Wells Fargo*, C.A. No. 14696, 1996 Del. Ch. LEXIS 3 (Jan. 18,

1996) (refusal to redeem rights plan and entry into stock-for-stock merger, including break-up fee and stock options capped at 2% of transaction value, can be a reasonable response to hostile offer).

That defensive measures may be well justified in a particular case should not, however, suggest that any and all protective devices will be upheld under *Unocal* in a non-control change transaction. The reasonableness inquiry is not a rubber stamp for directors' actions. A seller who attempts to build an impenetrable fortress against all third-party offers, by definition unknown at the time the devices are adopted, is not likely to receive deference similar to that evident in *Time.* "Excessive" stock options, strict no-shop clauses and other highly restrictive measures may not satisfy *Unocal.*

IV

Advance Takeover Preparedness and Responding to Unsolicited Offers

Although strategies implemented once an unsolicited offer has emerged can provide the board valuable time during which to evaluate a bid and determine the correct response, the importance of advance takeover preparedness cannot be overstated. A corporation that carefully employs advance takeover measures can improve its ability to deter coercive or inadequate bids or secure a high premium in the event of a sale of control of the corporation. Rights plans in particular are the most effective device yet developed to deter abusive takeover tactics and inadequate bids.[11] Economic studies have concluded that as a general matter takeover premiums are higher where

[11] See R. Comment & G. Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures,* 39 Journal of Financial Economics 1, 1 (1995) (87% of exchange-listed companies are covered by rights plans or control share laws, which anti-takeover measures are "reliably associated with higher takeover premiums for selling shareholders").

rights plans or modern anti-takeover statutes are in effect than in the absence of such provisions, and that a rights plan or similar protection increases the target's bargaining power. *See* Section IV.A.3. In addition, numerous studies have concluded that the negative impact, if any, of adoption of a rights plan on the company's stock price is very small (less than 1% over the period immediately preceding and following adoption of the plan) and is likely not statistically significant. Comment & Schwert, *Poison or Placebo?* at 18-21; R. Bruner, *The Poison Pill Anti-takeover Defense: The Price of Strategic Deterrence* at 24, 28 (The Institute of Chartered Financial Analysts 1991).

The importance of advance preparation for defending against a takeover may also be critical to the success of a preferred transaction that the board has determined to be part of the company's long-term plan. As discussed in Part I, a decision to enter into a business combination transaction does not necessarily obligate the board to serve merely as auctioneer. In the case of a merger or acquisition not involving a change of control, the board of directors may retain the protection of the business judgment rule in pursuing its corporate strategy. *See Time*, 571 A.2d 1140. As a practical matter, of course, an unsolicited offer involving a substantial premium over the market price may be difficult to ignore or ultimately avoid.

In addition to making good business sense, advance planning for an unsolicited takeover makes good legal sense. The courts have recognized that the business judgment rule is applicable both to preplanned strategies and to responses to a bid, but, as discussed in Part I, have held that defensive measures taken in response to a bid will be subject to a higher level of judicial scrutiny. *See Moran* v. *Household Int'l, Inc.,* 500 A.2d 1346, 1350 (Del. 1985); *Unocal,* 493 A.2d at 953-54.

The Delaware Supreme Court's landmark *Time* decision points up the absolute necessity for a company that desires to maximize its ability to reject a hostile takeover bid to consider periodically its long-term business and acquisition strategies. In *Time*, both the Delaware Chancery Court and Supreme Court were influenced heavily by the documented history of Time's long-term business and acquisition strategies and Time's prior consideration and rejection of Paramount as a merger partner. Under *Time*, Delaware courts respect and defer to a company's

long-term plans and will not force a company to accept a hostile takeover bid if its board of directors determines to reject the bid and pursue the long-term plans.

A. Rights Plans

Shareholder rights plans are the most effective device yet developed in response to abusive takeover tactics and inadequate bids and have become a central feature of most major corporations' takeover preparedness. The first version of the rights plan was developed in 1984. Today, over 2,300 companies have adopted rights plans that are in effect.

Rights plans do not interfere with negotiated transactions, nor do they preclude unsolicited takeovers. The evidence is clear, however, that they do have the desired effects of both forcing acquirors to deal with the target's board of directors and ultimately extracting from acquirors higher acquisition premiums than would otherwise have been the case.

The issuance of share purchase rights has no effect on the capital structure of the issuing company; rather, its only immediate effect is on the balance of negotiating power between the would-be acquiror, on the one hand, and the target and its shareholders, on the other hand. If an acquiror takes action to trigger the rights, however, dramatic changes in the capital structure of the target company and/or the acquiror can result.[12]

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[12] In the case of regulated financial institutions, a triggering event may also have significant consequences for the safety and soundness of either or both of the parties. The decision by Bank of New York in the Irving/Bank of New York matter to waive as conditions to its tender offer the requirements that Irving's rights be redeemed or invalidated and that Section 912 of the New York Business Corporation Law be made inapplicable to Bank of New York's offer, for example, raised the specter of presenting Irving shareholders with a dramatically different investment decision than they had faced earlier. In *Irving Bank Corp.* v. *Bank of New York Co.,* 692 F. Supp. 163, 170 (S.D.N.Y. 1988), the court issued a temporary restraining order prohibiting Bank of New York from

(footnote continued)

A rights plan carefully drafted to comply with state law and the company's charter remains the basic and most effective protective device to prevent coercive offers and disruption of a company's long-term business strategy.

1. The Basic Design

The key features of a rights plan are the "flip-in" and "flip-over" provisions of the rights, the effect of which, in specified circumstances, is to impose unacceptable levels of dilution on the acquiror. The risk of dilution, combined with the authority of a target's board of directors to redeem the rights prior to a triggering event (generally an acquisition of 15% or 20% of the target's stock), gives a potential acquiror a powerful incentive to negotiate with the target's board of directors rather than proceeding unilaterally.

The rights plan should also provide that, once the triggering threshold is crossed, the target company's board may exchange, in whole or in part, the rights of all holders other than the acquiror for one share of the company's common stock. This provision avoids the expense of requiring rights holders to exercise their flip-in rights, eliminates any uncertainty as to whether individual holders will in fact exercise the rights, producing the intended dilution, and provides the board additional flexibility in responding to a triggering event. In cases where the acquiring person holds less than 50% of the company's stock, the dilution caused by implementation of the exchange feature is substantial and can be roughly comparable to the dilution caused by the flip-in provision, assuming all eligible rights holders exercise their rights. The exchange also

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(footnote continued)

purchasing any shares of Irving's common stock until Bank of New York first issued and disseminated a prospectus supplement to shareholders disclosing, among other things, certain effects of the waiver on their investment decision. The Federal Reserve Board also expressed the concern that "'under certain circumstances consummation of the proposal might have an adverse effect on the capital adequacy, financial and managerial resources and future prospects of the institutions.'" *Id.*

allows the board to control the amount of dilution since these provisions typically provide that the rights may be exchanged in whole or in part.

In order to satisfy activist shareholders, some companies have resorted to a rights plan that does not apply to a cash offer for all of the outstanding shares. Recent versions of this exception have limited its scope to cash offers containing a specified premium over the market price of the target's stock. While a so-called "chewable pill" rights plan has some limited utility and may avoid a proxy resolution attack, it is not effective in most situations, and may create an artificial "target price" for the Company that does not maximize shareholder value.

2. Basic Case Law Regarding Rights Plans

There is now no doubt as to the legality of poison-pill rights plans. Rights plans, properly drafted to comply with state law and the company's charter, typically survive judicial challenge, including under a *Unocal* analysis.[13] *See*, *e.g.,*

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[13] Rights plans for Canadian companies are generally subject to closer judicial scrutiny in the context of a possible sale of the company. In two recent decisions regarding rights plans and unsolicited takeover offers, the Ontario Securities Commission ("OSC") has indicated that whether the rights plan will continue in effect depends on various factors, including: (1) whether shareholder approval of the plan was obtained, (2) the extent to which shareholders were consulted in designing the rights plan, (3) shareholders' view of the rights plan following announcement of the offer and (4) whether the board is engaged in a good-faith process to maximize shareholder value. *See In the matter of Lac Minerals Ltd. and Royal Oak Mines Inc.* (Oct. 13, 1994); *In the matter of MDC Corporation and Regal Greetings & Gifts Inc.* (Sept. 9, 1994). The OSC's view of these factors may result in an order to "cease trading" the rights even if the rights plan was properly adopted. Although a Canadian company may implement a rights plan without shareholder approval in response to an unsolicited bid, the OSC has been willing to suspend a plan in order to permit shareholders to choose whether to accept an offer, particularly in the context of an active bidding process for a company. *In the matter of Ventra Group Inc. and The Tarxien Corporation* (Dec. 13, 1996).

Moran, 500 A.2d at 1346. The "flip-in" feature of the plan was held, in some early cases, to violate state corporate law. These rulings, however, have now been overruled, either judicially or by legislation explicitly authorizing the flip-in.

Therefore, almost all litigation concerning rights plans now focuses on whether or not a board of directors should be required to redeem the rights in response to a particular bid. In this respect, courts applying Delaware law have upheld, or refused to enjoin, determinations by boards of directors not to redeem rights in response to two-tier offers, *Desert Partners, L.P.* v. *USG Corp.,* 686 F. Supp. 1289 (N.D. Ill. 1988), or inadequate 100% cash offers, *BNS Inc.* v. *Koppers Co.,* 683 F. Supp. 458, 474-75 (D. Del. 1988); *Moore Corp.* v. *Wallace Computer Services, Inc.*, 907 F. Supp. 1545 (D. Del. 1995), as well as to protect an auction or permit a target to explore alternatives. *CRTF Corp.* v. *Federated Dept. Stores, Inc.,* 683 F. Supp. 422, 438-42 (S.D.N.Y. 1988) (refusing to enjoin discriminatory application of poison pill during auction); *MAI Basic Four, Inc.* v. *Prime Computer, Inc.,* [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,179 (Del. Ch. 1988); *In re Holly Farms Corp. Shareholders Litig.,* [1988-89 Transfer Binder] Fed. Sec. L. Rep. ¶ 94,181 (Del. Ch. 1988).

On the other hand, some decisions have held that the rights may not interfere with shareholder choice at the conclusion of an auction, *Mills Acquisition Co.* v. *Macmillan, Inc.,* [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch. 1988), *rev'd on other grounds,* 559 A.2d 1261 (Del. 1989), or at the "end stage" of a target's attempt to develop alternatives. *City Capital Associates Ltd. Partnership* v. *Interco, Inc.,* 551 A.2d 787, 798-800 (Del. Ch.), *appeal dismissed,* 556 A.2d 1070 (Del. 1988); *Grand Metropolitan Public, Ltd.* v. *Pillsbury Co.,* 558 A.2d 1049 (Del. Ch. 1988). Importantly, both *Pillsbury* and *Interco* involved circumstances in which the board of directors, rather than "just saying no," had pursued a restructuring that was comparable to the pending all-cash tender offer. *See TW Services* v. *SWT Acquisition Corp.,* C.A. No. 10427, 1989 Del. Ch. LEXIS 19, at 24-25 (Mar. 2, 1989); *Paramount Communications Inc.* v. *Time Inc.,* [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,283 (Del. Ch.) (in *Pillsbury* and *Interco,* management sought to "'cram down' a transaction that was the functional

equivalent of the very leveraged 'bust up' transaction that management was claiming presented a threat to the corporation"), *aff'd,* 571 A.2d 1140 (Del. 1989). In its opinion in *Time,* the Delaware Supreme Court criticized some of these cases as reading *Unocal* to permit "substituting [the court's] judgment as to what is a 'better' deal for that of a corporation's board of directors." *Time,* 571 A.2d at 1153 (disapproving of *Interco* and its progeny).

The case law regarding the board's obligation to redeem rights plans essentially follows the logic of the Delaware courts' sale of control/non-control transaction case law, as well as the basic *Unocal* standard. Thus, a board engaged in the sale of control of the company may not apply a rights plan in a discriminatory manner favoring one change in control transaction over another, *see QVC,* but, in the non-change in control context, it may implement or strengthen an existing rights plan, including to favor a preferred strategic merger, as part of a business strategy to remain independent, *see Unitrin; Time*; *In re Santa Fe Pacific Corp.,* C.A. No. 13587, 1995 Del. Ch. LEXIS 70 (May 31, 1995), *aff'd in part, rev'd in part, both on other grounds*, 669 A.2d 59 (Del. 1995). In the context of a response to an unsolicited offer, a board adopting a rights plan is well-advised to consider the adequacy of the unsolicited offer and its impact on the company's long-term business strategy. The board may also benefit in the *Unocal* analysis from an investment banker's inadequacy opinion, although courts have not required such opinions in the context of a "just say no" response to an unsolicited offer. *See Amanda Acquisition Corp.* v. *Universal Foods Corp.,* 708 F. Supp. 984, 1010-11, 1013-14 (E.D. Wis.), *aff'd on other grounds,* 877 F.2d 496 (7th Cir.), *cert. denied,* 493 U.S. 955 (1989).

3. Renewal of Rights Plans, Shareholder Proposals and the Economic Evidence

Over the past few years, many rights plans adopted shortly after creation of these protective measures in 1984 were scheduled to expire and have generally been renewed. In view of the demonstrated success of rights plans in avoiding coercive and abusive takeover tactics and in protecting the board's right to "just say no" to a low bid or a bid not consistent with the company's long-term strategy, renewal of rights plans is

sensible and warranted. Renewal of a rights plan does not require stockholder approval, unless the plan itself provides otherwise. Renewal also provides the board with an opportunity to amend the rights plan to reflect developments included in later-generation rights plans, as well as in the applicable state corporate and case law.

Shortly after the poison pill became popular with major companies, activist institutional shareholders, like CREF, sponsored precatory resolutions attacking the pill. Today, many institutions routinely vote for such resolutions and currently companies with very large institutional ownership may expect about 50% of the shares to vote for such resolutions. In 1997, anti-pill resolutions went to a vote at 17 companies (passed at 9 companies) and on average received 54.1% of the votes cast. Generally, those companies have had performance problems and the anti-pill resolution vote usually bears a direct relationship to performance.

In response to institutional pressure, a few companies have agreed to either redeem their rights plans in three to four years or seek shareholder ratification. Several other companies, including Texaco, have solicited and received shareholder ratification of their rights plans. A few companies voluntarily redeemed rights plans when takeover activity lessened in the early 1990s. Time-Warner, which had redeemed its rights plan in response to institutional shareholder pressure, reinstituted a rights plan with a 15% threshold in response to open market purchases by The Seagram Company. Many institutional investors have come to recognize, however, that a rights plan can be an effective negotiating tool for a responsible board of directors.

Since the invention of rights plans in 1984, economists and market analysts have debated the economic impact of rights plans on the market price of a company's stock as well as on takeovers and takeover premiums. Although a 1986 study by the SEC comparing market prices of companies' stock prior to and immediately after announcement of the adoption of a rights plan found a "statistically significant" reduction in market price of 0.66% in some circumstances, every major investment bank that studied the matter has concluded that adoption of a rights plan has no effect on the stock prices of companies that are not

the subject of takeover speculation. The analysis of Comment and Schwert, who used the same methodology as the SEC study but with a database four times the size of the SEC study, indicated that adoption of a rights plan has no meaningful price effect on the company's stock price. A recent study of 341 rights plans adopted between January 1, 1998 and October 31, 1998 concluded that "the announcement of the adoption of a stockholder rights plan had no effect on the average company's stock price."[14]

Moreover, a 1988 Georgeson & Company Inc. study demonstrated that companies with rights plans received substantially higher premiums than companies without rights plans. This conclusion has been reaffirmed by other studies, including that by Comment and Schwert. They concluded that rights plans are "reliably associated with higher takeover premiums." Comment & Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures,* in preface. According to one published report based on analysis by a major investment bank of 245 deals between 1988 and 1995, each with a market value in excess of $500 million, the median premium for a company with a rights plan was 51%, compared to 35% for companies not having rights plans.

4. The New Frontier: "Dead Hand" Pills and the Fleming By-Law

Dead Hand Pills. In the face of a "Just Say No" defense, the takeover tactic of choice has become a combined tender offer and solicitation of proxies or consents to replace target's board with directors committed to redeeming the poison pill to permit the tender offer to proceed. The speed with which this objective can be accomplished depends, in large part, upon other defenses that the target has in place. In Delaware, a bidder can act by written consent without a meeting of stockholders, unless such action is prohibited in the

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[14] Houlihan Lokey Howard & Zukin Stockholder Rights Plan Study, January 1999, at 2.

certificate of incorporation, and can call a special meeting between annual meetings, if permitted under the target's by-laws. Conversely, if the target has a staggered board, a bidder can generally only replace a majority of the target's Board by waging a proxy fight at two consecutive annual meetings.

Thus, if the target's charter does not prohibit action by written consent and does not provide for a staggered board, a bidder can launch a combined tender offer/consent solicitation and take over the target as soon as consents from the holders of more than 50% of the outstanding shares are obtained. Even if its charter prohibits action by written consent and precludes stockholders from calling a special meeting, a target without a staggered board can essentially be taken over once a year: by launching a combined tender offer/proxy fight shortly before the time of the target's annual meeting. In contrast, a target with a staggered board may well be takeover proof until the second annual meeting.

Within this framework, a target in the first category cannot rely on an ordinary poison pill to give much protection in the face of a combined tender offer/proxy fight. The predicament faced by such targets has spawned variants of the so-called "continuing director" or "dead hand" pill.

"Pure" dead hand pills permit only directors who were in place prior to a proxy fight or consent solicitation (or new directors recommended or approved by them) to redeem the rights plan. Once these "continuing directors" are removed, no other director can redeem the pill. The Cordis board of directors adopted such a pure continuing director redemption provision in 1995 when faced with a consent solicitation to replace its board with the nominees of Johnson & Johnson. As described in a filing on Form 8-K by Cordis, under its rights plan:

> [T]he Board of Directors may cause the Company to redeem the Rights in whole, but not in part, at any time during the period commencing on October 12, 1995 and ending on the tenth day following the Stock Acquisition Date, as such period may be extended or shortened by the Board (the "Redemption Period") at a price of $.005 per Right (payable in cash, Common Stock or other

> consideration deemed appropriate by the Board of Directors). *Under certain circumstances set forth in the Rights Agreement, the decision to redeem the Rights will require the concurrence of a majority of the Continuing Directors*. After the redemption period has expired, the Company's right of redemption may be reinstated (with the concurrence of the Continuing Directors) if an Acquiring Person reduces his beneficial ownership to 10% or less of the outstanding shares of Common Stock in a transaction or series of transactions not involving the Company and there are no other Acquiring Persons. Immediately upon the action of the Board of Directors of the Company ordering redemption of the Rights, with, where required, the concurrence of the Continuing Directors, the Rights will terminate and the only right of the holders of Rights will be to receive the $.005 redemption price.
>
> *The term "Continuing Director" means any member of the Board of Directors of the Company who was a member of the Board prior to the date of the Rights Agreement, and any person who is subsequently elected to the Board if such person is recommended or approved by a majority of the Continuing Directors, but shall not include an Acquiring Person or an affiliate or associate of an Acquiring Person, or any representative of the foregoing entities*. The term "Outside Directors" means "Continuing Directors" who are not officers of the Company. [emphasis added]

J&J challenged the Cordis rights plan under Florida law, but the parties agreed to a merger before the litigation reached any conclusion.

Modified dead hand provisions come in a variety of forms. So called "nonredemption" or "no hand" provisions typically provide that no director can redeem the rights plan once the continuing directors no longer constitute a majority of the board. This limitation on redemption may last for a limited period or for the remaining life of the pill. The rights plan at issue in the *Quickturn* case discussed below included such a provision.

Another variant is the "limited duration," or "delayed redemption," dead hand pill. This feature can be attached to either the pure dead hand or no hand rights plan. As the name indicates, these pills limit a dead hand or no hand restriction's effectiveness to a set period of time, typically starting after the continuing directors no longer constitute a majority of the board. These rights plans delay, but do not preclude, redemption by a newly elected board. The rights plan that Martin Davis confronted in his attempted takeover of Northwest Airlines provided that a newly-elected board could not redeem the pill for a period of 180 days after the meeting. *See Davis Acquisition Inc. v. NWA Inc.*, 1989 Del., Ch. LEXIS 39 (April 25, 1989).

Some dead hand rights plans broaden the concept of continuing directors to include more persons than the pure dead hand pill does, creating a milder form of dead hand pill. Rights plans such as that of Irving Bank Corp. discussed below define continuing directors to include not only directors who were members of the board at the time of the rights plan's adoption (or who were recommended or approved by such persons) but also directors who were elected by a supermajority vote of the shareholders. Such adaptations leave open the possibility that, before a potential acquiror purchases enough shares to trigger the rights plan, it could conduct a proxy contest or consent solicitation to replace the board with its slate of directors who could then redeem the rights without being subject to the dead hand limitations.

The validity of dead hand provisions depends in large part upon the state law that applies. Delaware recently has made clear that dead hand provisions – even of limited duration – are invalid. *See Quickturn Design Systems, Inc.* v. *Shapiro*, Del. Supr., No. 51, 1998 (Dec. 31, 1998). At issue in *Quickturn* was a no hand pill provision of limited duration that the Quickturn Design Systems board had adopted in the face of a combined proxy fight and tender offer by Mentor Graphics Corp. The pill provision barred a newly elected board from redeeming the rights plan for six months after taking office if the purpose or effect would be to facilitate a transaction with a party that supported the new board's election. The Chancery Court struck down the delayed redemption no hand provision of the pill on fiduciary duty grounds. Applying the *Unocal*

standard, the lower court found that this particular pill, which effectively barred transactions only with Mentor, was an impermissibly disproportionate response to the threat posed by the bidder.

On appeal, the Delaware Supreme Court reached the same result but on different grounds. The court held that the dead hand feature of the rights plan ran afoul of Section 141(a) of the Delaware corporation statute, which empowers the board of directors with the statutory authority to manage the corporation. Relying on the requirement in Section 141(a) that any limitation on the board's power must be stated in the certificate of incorporation, the court found that dead hand provision would prevent a newly elected board "from completely discharging its fundamental management duties to the corporation and its stockholders for six months" by restricting the board's power to negotiate a sale of the corporation. *Quickturn*, at 29. The reasoning behind the *Quickturn* holding leaves little room for dead hand provisions of any type in Delaware. *See also Carmody* v. *Toll Brothers, Inc.*, C.A. No. 15983, 1998 Del. Ch. LEXIS 131 (July 24, 1998).

Nothing in the *Quickturn* decision undercuts the validity or usefulness of traditional rights plans or the readoption of rights plans in anticipation of the expiration of a company's current rights plan. Indeed, the *Quickturn* court expressly relied in its analysis on the reasoning in *Moran* that upheld the board's authority to adopt rights plans. *See Quickturn*, at 27-28. The *Quickturn* decision does suggest that Delaware corporations with dead hand provisions in their rights plans should proactively seek counsel regarding amendment of their plans before stockholder litigation arises.

Irving Bank's defense against a hostile offer by Bank of New York in the late 1980's provided an opportunity for New York to examine the validity of dead hand pills. Irving Bank, incorporated in New York, amended its rights plan to provide that the rights could only be redeemed by the existing directors of Irving Bank or new directors who had been elected by a vote of two-thirds of the outstanding shares (as opposed to the ordinary plurality for election of directors). The Irving Bank plan provided that:

> The Board of Directors of the Company may, at its option at any time prior to such time as any Person becomes an Acquiring Person, redeem all but not less than all the then outstanding Rights at a redemption price of $.01 per Right, appropriately adjusted to reflect any stock split, stock dividend or similar transaction occurring after the date hereof (such redemption price being hereinafter referred to as the "Redemption Price"); *provided, however, that, except as set forth in the following sentence, the Board of Directors of the Company shall be entitled so to redeem the Rights only if it consists of a majority of Continuing Directors (as hereinafter defined) or, if the Board of Directors of the Company is not so constituted, only if the members of the Board of Directors of the Company who are not Continuing Directors were elected to immediately succeed Continuing Directors and either (i) were elected by the affirmative vote of the holders of at least two-thirds of the issued and outstanding Shares of the Company* or (ii) in connection with the election of the members of the Board of Directors of the Company who are not Continuing Directors, no merger, consolidation, liquidation, business combination or similar transaction or series of transactions with respect to the Company is or was proposed. The term "Continuing Director" shall mean a director who either was a member of the Board of Directors of the Company prior to March 15, 1988 or who subsequently became a director of the Company and whose election, or nomination for election by the Company's shareholders, was approved by a vote of a majority of the Continuing Directors then on the Board of Directors of the Company. [emphasis added]

The Irving Bank rights plan was a relatively mild version of a continuing director redemption provision: it did not preclude a proxy fight as a means to replace the Board and redeem the pill, it just raised the hurdle to a vote of two-thirds of the outstanding shares.

Irving Bank lost. *See Bank of New York Company, Inc.* v. *Irving Bank Corp.,* 528 N.Y.S. 2d 482 (N.Y. Sup. Ct. 1988) *("Irving Bank").* The New York court in *Irving* held that the provision limiting redemption impermissibly classified directors

into those who could redeem the poison pill and those who could not. The decision also contained some strong language, albeit in dictum, against the concept of a dead-hand pill:

> By statute, any restriction on the power of the board of directors must be placed in the Certificate of Incorporation . . . the board of directors was without authority to adopt a provision restricting the action of a future board.

Irving Bank, at 485.

Not all states have come down against dead hand rights plans. In a test of the validity of a pure dead hand pill under Georgia law, a federal court upheld such a provision. *Invacare Corporation* v. *Healthdyne Technologies, Inc.,* 968 F. Supp. 1578 (N.D. Ga. 1997). The *Invacare* court rejected the offeror's contention that a dead hand pill impermissibly restricts the power of future boards of directors – including a board elected as part of a takeover bid – to redeem a rights plan. The court relied upon the "plain language" of a Georgia statute that expressly grants a corporation's board the "sole discretion" to determine the terms contained in a rights plan.

In the context of AlliedSignal Inc.'s contest for control of AMP Incorporated, a Pennsylvania federal court recently validated a no hand rights plan under Pennsylvania law. *See AMP Incorporated* v. *AlliedSignal Inc.*, C.A. Nos. 98-4405, 98-4058, and 98-4109, 1998 U.S. Dist. LEXIS 15617 (E.D. Penn. 1998). Faced with a combined consent solicitation and tender offer by AlliedSignal, the AMP board replaced a pure dead hand provision in its rights plan with a no hand provision preventing redemption until the pill's expiration some fourteen months later. The federal district court reviewing the AMP board's action concluded that the adoption of the no hand rights plan was within the authority granted to the board pursuant to a Pennsylvania statute that, like the Georgia statute in *Invacare*, bestowed upon a board considerable latitude in selecting the terms of a pill.

As indicated above, rights plans that provide for redemption only by "continuing directors" can be critical in takeover situations where the target company lacks a staggered

board and, following *Invacare* and *AMP*, may become more attractive to firms incorporated in states such as Georgia and Pennsylvania which have adopted pill validation statutes confirming the board's ability to design the terms of a rights plan.

Fleming Bylaw. At the recent annual meetings of Fleming Companies and Harrah's Entertainment, shareholders indicated significant support for shareholder-proposed resolutions to amend corporate bylaws in a way that would require the corporation to redeem its shareholder rights plan and prevent the corporation from adopting a new rights plan absent shareholder approval. Like most recent shareholder proposals on rights plans, the Fleming and Harrah's proposals were from unions. However, these new shareholder proposals, which are not precatory and purport to be binding bylaw amendments, are attracting increasing interest from significant institutional shareholders and corporate governance activists.

At the trial court level, a federal district court found that Fleming, an Oklahoma corporation, could not exclude the shareholder-proposed amendment to its bylaws from its proxy solicitation materials. *International Brotherhood of Teamsters Gen. Fund* v. *Fleming Companies, Inc.* 1997 U.S. Dist. LEXIS 2980 (W.D. Okla. Jan. 24, 1997). The district court's decision was predicated upon the conclusion that the proposed bylaw would be valid under Oklahoma law. Although it was asserted in *Fleming* that Oklahoma law was similar to Delaware law in relevant respects, the extensive Delaware jurisprudence on the powers of a board responding to a takeover threat was not alluded to in the *Fleming* decision.

On appeal, the Court of Appeals for the Tenth Circuit certified the bylaw issue to the Oklahoma Supreme Court. The state supreme court held that shareholders of Oklahoma corporations may propose bylaws that restrict the board of director's implementation of rights plans, absent a provision in the charter to the contrary. *See International Brotherhood of Teamsters General Fund* v. *Fleming Companies, Inc.,* No. 90,195, 1999 OK 3 (Jan. 26, 1999). The court reasoned that since the Oklahoma corporations statute vests authority over rights plans in the corporation and not solely in the board, "the board may well be subject to the general procedures of

corporate governance, including the enactment of bylaws which limit the board's authority to implement shareholder rights plans." *Fleming*, at para. 25. The court noted that had Oklahoma enacted a statute that specifically validated the board's power to adopt rights plan like the pill validation statutory provisions that exist in 24 other states, it would have found the proposed bylaw invalid. Like the federal district court, the state supreme court noted a substantial similarity between the Oklahoma and Delaware statutory provisions on point, but failed to address the Delaware case law regarding the board's power in the takeover context. Rather, the court focused on the similarity of rights plans to option plans and the fact that shareholders had been asked to ratify option plans in the past.

Contrary to the recent *Fleming* decision under Oklahoma law, the *Invacare* court invalidated a proposed bylaw amendment aimed at compelling the target board to remove the "dead hand" provision of the rights plan. The court ruled that such a bylaw would undercut the statutory powers and authority of the board and be "inimical to the corporate structure contemplated by the Georgia Business Corporation Code." *Invacare*, 968 F. Supp. at 1582.

The *AMP* court reached a similar result under Pennsylvania law. *See AMP*, at 5-6. The bylaw proposal at issue sought to remove from the AMP board all power, rights and duties with respect to the pill and to place this power in the hands of a designated three-person committee (AlliedSignal simultaneously proposed expanding the board and filling the new positions with its own nominees). The federal court held that the proposed bylaw violated the Pennsylvania corporation statute, which gives the board the ability to fix the terms of a rights plan.

It would seem that the bylaw amendments proposed in *Fleming*, *Invacare* and *AMP* should be held invalid under Delaware law as an unauthorized infringement on the statutory power of a board of directors to manage the "business and affairs" of a Delaware corporation. Delaware cases have long made clear that the responsibility of responding to a takeover lies with the Board and may not be delegated to shareholders. The statutory grounding of the recent *Quickturn* decision

supports this reading of Delaware law. If a proposed bylaw amendment is contrary to applicable law, the shareholder proposal can be excluded from a corporation's proxy statement under Exchange Act Rule 14a-8. However, this issue has not been fully addressed by the Delaware courts and, until it is, the SEC may not agree that these purportedly binding bylaw amendment shareholder proposals can be excluded from proxy statements.

B. Defensive Charter and By-Law Provisions

Defensive charter and by-law provisions typically do not purport to, and will not, prevent a hostile acquisition. Rather, they provide some measure of protection against certain takeover tactics and allow the board of directors some additional negotiating leverage. Provisions of this kind include the following: "fair price" provisions (which require that shareholders receive equivalent consideration at both ends of a two-step bid, thus deterring coercive two-tier, front-end loaded offers); classified or staggered board provisions; provisions which eliminate shareholder action by written consent; cumulative voting provisions; provisions affecting the ability of shareholders to remove directors without cause and to alter the size of the board; and by-law procedures governing shareholder nominations for directors and the submission of shareholder proposals at meetings. Classified boards and fair-price charter provisions require shareholder approval to be implemented and, due to general institutional investor opposition to such provisions, few companies have put forth new proposals in recent years. *See* N.Y. Corp. Law § 704(a); 8 Del. Code Ann. § 141(d).[15] By-law provisions governing the calling of, and the

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[15] Under Delaware law, directors on a staggered board can be removed only for cause, unless the certificate of incorporation provides otherwise. 8 Del. Code Ann. § 141(k). Delaware corporations should make sure that supermajority amendment requirements apply to the amendment of classified board and removal provisions. *See Roven* v. *Cotter,* 547 A.2d 603 (Del. Ch. 1988) (allowing stockholder amendment of certificate of incorporation to eliminate staggered board so that directors may be removed without cause).

business to be addressed at, shareholder meetings can be adopted without shareholder approval in Delaware. Such provisions should be reviewed periodically to ensure that they are consistent with recent case law and SEC developments.

By-law provisions regarding the business to be conducted at, and the manner of presenting proposals for, annual and special meetings, as well as shareholder action by written consent, can be especially helpful in protecting against an unexpected proxy contest for control of the board of directors. Typical recent amendments to these procedures include:

- *Nominations and Stockholder Business*: By-law provisions requiring stockholders to provide advance notice of business proposed to be brought before, and of nominations of directors to be made at, shareholder meetings have become common. These provisions generally set a date by which a shareholder must advise the corporation of his intent to seek to take action at a meeting and fix the contents of the notice, which can include information such as beneficial stock ownership and other information required by Regulation 14A of the federal proxy rules. Failure to deliver proper notice in a timely fashion usually results in exclusion of the proposal from shareholder consideration at the meeting.

- *Shareholder Meetings*: If, as in Delaware, *see* 8 Del. Code Ann. § 211(d), the state corporation law permits elimination of the calling by shareholders of special meetings, such a by-law provision may be helpful in regulating shareholder meetings. Where state law does not so permit, corporations should consider adopting by-law provisions to regulate the ability to call special meetings.

- *Scheduling Annual Meetings*: Many by-laws specify a particular date for the meeting. This

should be amended to authorize the board to set an alternative date.

- *Postponements*: The board should be authorized to postpone previously scheduled annual meetings upon public notice given prior to the scheduled meeting date.

- *Adjournments*: The chairman of the shareholder meeting should be specifically authorized to adjourn the meeting from time to time whether or not a quorum is present. Adjournments and postponements may help prevent premature consideration of a coercive or inadequate bid.

- *Vote Required*: To approve a proposal, except for election of directors (which requires a plurality of the quorum), the required shareholder vote should not be less than a majority of the shares present and entitled to vote at the meeting (*i.e.*, abstentions should count as no votes for shareholder resolutions). For Delaware corporations, § 216 of the Delaware General Corporation Law dictates this result unless the charter or by-laws specify otherwise.

- *Procedures for Action by Stockholder Consent*: If the corporation's charter does not disallow action by stockholder consent in lieu of a meeting, the by-laws should establish procedures for specifying the record date for the consent process, for the inspection of consents and for the effective time of consents. Although Sections 213 and 228 of the Delaware General Corporation Law contemplate such procedures, Delaware courts have closely reviewed these provisions to determine whether their real purpose is delay and whether the procedures are unreasonable. *See, e.g., Allen* v. *Prime Computer, Inc.,* 540 A.2d 417 (Del. 1988); *Edelman* v. *Authorized Distribution Network, Inc.,* C.A. No. 11104, 1989 Del. Ch. LEXIS 156

(Nov. 3, 1989); *Nomad Acquisition Corp.* v. *Damon Corp.,* C.A. No. 10173, 1988 Del. Ch. LEXIS 133 (Sept. 20, 1988).

Delaware courts have affirmed the board's ability to adopt reasonable by-law amendments in response to a hostile offer. In litigation arising out of the unsolicited bid by SoftKey International to acquire The Learning Company ("TLC"), the Delaware courts upheld the TLC board's decision to amend a by-law in order to delay a special TLC stockholder meeting demanded by SoftKey. SoftKey had demanded the meeting under TLC's existing by-law, which authorized holders of 10% or more of the shares to call a special meeting on 35 days' notice; SoftKey sought to replace the TLC directors in order to redeem TLC's rights plan and implement SoftKey's takeover. In response, the TLC board amended the by-law to require a minimum of 60 days' notice. That delay enabled TLC to schedule the vote on its previously-announced stock merger with Broderbund Software approximately 30 days in advance of the SoftKey removal meeting. The board's action was defended on the basis that the delay gave the board a reasonable period of time to seek better alternatives to SoftKey's offer in the event the stockholders were to reject the Broderbund merger. Without the by-law amendment, the SoftKey-initiated removal meeting would have occurred two days after the then-scheduled meeting on the Broderbund merger. In an opinion by Vice Chancellor Jacobs, the Court of Chancery upheld the by-law amendment. *Kidsco, Inc.* v. *Dinsmore*, 674 A.2d 483 (Del. Ch. 1995), *aff'd on opinion below*, 670 A.2d 1338 (Del. 1995) (Order). The court tested the amendment under the *Unocal* reasonable proportionality test, and found SoftKey's tactics to constitute a threat to legitimate stockholder interests inasmuch as SoftKey's goal was to "circumven[t] the current board's negotiating power." *Kidsco*, 674 A.2d at 496. The decision was affirmed by the Delaware Supreme Court on the basis of the opinion below.

Although more difficult to effect and subject to shareholder approval, amendments to a company's charter can also support the board's efforts to remain independent. Charter amendments related to the voting rights of common stockholders are infrequent but have been upheld in court. Under a "tenure voting" provision, newly-transferred shares of

stock lose their supervoting characteristic until held by one beneficial owner for a set time, typically 2-4 years. Such charter provisions can deter creeping acquisitions of a large voting bloc and also generally encourage investors to become long-term holders of the company's stock. *See Williams* v. *Geier*, 671 A.2d 1368 (Del. 1996). A tenure voting structure may adversely affect the valuation and liquidity of a company's stock, and must comply with stock exchange and NASD rules relating to disparate voting rights. A board considering such a voting structure should receive the advice of investment bankers and legal advisors prior to presenting the proposal for shareholder approval. In addition, companies seeking to implement defensive charter amendments will need to address the general opposition of institutional investors to such measures.

C. Change of Control Employment Agreements

In addition, change of control employment and benefit arrangements should be reviewed to ensure that senior executives and other employees will be properly protected in the event of a merger or other business combination. In the event of a takeover involving a change of control or a strategic merger, senior executives typically face a great deal of pressure, including the uncertainty of their own future, and such arrangements help assure their full participation in the merger negotiation process. Appropriately structured change of control employment agreements are both legal and proper. Careful attention must be paid to tax, regulatory and other legal concerns. Although there is little case law relating to the adoption of such agreements, they have typically been found, absent a conflict of interest, enforceable and consistent with directors' fiduciary duties. *See, e.g.*, *Moore Corp., Ltd.* v. *Wallace Computer Services, Inc.*, 907 F. Supp. 1545 (D. Del. 1995); *Buckhorn, Inc.* v. *Ropak Corp.,* 656 F. Supp. 209 (S.D. Ohio), *aff'd,* 815 F.2d 76 (6th Cir. 1987).

As part of the Tax Reform Act of 1984, as amended by the Tax Reform Act of 1986, Congress imposed so-called "golden parachute" tax penalties on certain change of control payments in an effort to curb perceived abuses. The rules governing the application of these tax penalties are complex

and, despite substantial explication in the applicable legislative history and proposed regulations, are unclear in many respects.

The golden parachute tax rules subject "excess parachute payments" to a dual penalty: the imposition of a 20% excise tax upon the recipient employee and non-deductibility of such payments by the paying corporation. Excess parachute payments result if the aggregate payments received by an employee that are "contingent on a change of control" equal or exceed three times the employee's "base amount" (the average annual taxable compensation of the employee for the five years preceding the year in which the change of control occurs). In such a case, the excess parachute payments are equal to the excess of such aggregate change of control payments over one times the employee's base amount. Payments which constitute "reasonable compensation" for services actually rendered may be excluded from excess parachute payments in some cases. Tax counsel can assist in developing approaches to address the consequences of golden parachute tax penalties.

Companies may also wish to consider so-called "tin parachutes" for less senior executives in order to formalize company policies regarding severance, as well as the appropriate treatment of stock-based compensation plans in the event of a change of control.

D. Passive Responses to Unsolicited Offers – "Just Say No"

The developments in strategic mergers and related case law do not undercut the "just say no" defense to merger proposals. Indeed, unless the target has subjected itself to *Revlon* duties, it seems clear that the target may, if it meets the relevant standard, just say no to an acquisition proposal. If the proposal calls for a transaction that does not involve a change in control within the meaning of *QVC,* it would appear that the traditional business judgment rule would apply to the directors' decision. If the acquisition proposal calls for a transaction that would involve a change in control within the meaning of *QVC*, the enhanced-scrutiny *Unocal* test would apply.

Targets of unsolicited offers have been successful in rejecting such proposals in order to follow their own strategic

plan. In response to a hostile bid by Moore Corp., Wallace Computer Services Inc. relied on its rights plan and long-term strategy, rather than seeking a white knight, initiating a share repurchase program, or electing another "active" response to Moore's offer. When Moore challenged the pill in Delaware federal district court, Wallace was able to satisfy the *Unocal* standard. Although 73% of Wallace's shareholders tendered into Moore's offer, the court found that the Wallace Board had sustained its burden of demonstrating a "good faith belief, made after reasonable investigation, that the Moore offer posed a legally cognizable threat" to Wallace. The evidence showed that the favorable results from a recently adopted capital expenditure plan were now "beginning to be translated into financial results which even surpass management and financial analyst projections." *See Moore Corp. Ltd.* v. *Wallace Computer Services, Inc.*, 907 F. Supp. 1545, 1558, 1560 (D. Del. 1995). As the *Moore Corp.* decision also illustrates, where the target of a hostile bid wishes to consider rejecting the bid and remaining independent, it is critical that the board of directors follow the correct process and have the advice of an experienced investment banker and legal counsel.

While *QVC* does not limit the ability of a company that has entered into a strategic stock merger that is not a sale of control (but that may involve a premium to the seller's stockholders) from deciding to cancel (or continue) such merger after the appearance of a third-party hostile bid and reject the hostile bid, as a practical matter the seller's stockholders may pressure the company into accepting one or the other bid, or putting itself up for auction. This reality underscores the importance of careful planning prior to pursuit of even friendly stock-for-stock business combinations.

E. Active Responses to Unsolicited Offers

1. White Knights and White Squires

A white knight transaction, namely a merger or acquisition transaction with a friendly acquiror, can be a successful strategy where the white knight transaction provides greater economic value to target company shareholders than the initial hostile offer. In some contexts, however, white knight transactions, because of required regulatory approvals and

related procedures, are generally somewhat more difficult to accomplish. For example, in a banking or telecommunications acquisition, a white knight will require the same regulatory approvals as are required by the hostile acquiror and, to the extent that it commences the approval process after the hostile acquiror commences such approval process, will suffer a timing disadvantage as a result. In addition, while obtaining regulatory approval for the white knight transaction will be facilitated by the target's support, it can be assumed that the hostile acquiror will make every effort to prevent that approval from being granted. Certain target companies may also be constrained by a scarcity of available acquirors, depending upon the applicable regulatory restrictions and antitrust considerations. Advance planning is imperative.

A white squire defense, which involves placing a block of voting stock in friendly hands, may be more quickly realized. The 1989 decision of the Delaware Chancery Court upholding the issuance of convertible preferred stock by Polaroid Corporation to Corporate Partners, in the face of an all-cash, all-shares tender offer marks the most significant legal test of the white squire defense. *Shamrock Holdings, Inc.* v. *Polaroid Corp.*, 559 A.2d 278 (Del. Ch. 1989). Although the technique of a white squire defense combined with a self-tender offer at market or a slight premium to market was used defensively by Diamond Shamrock Corporation and Phillips-Van Heusen Corporation in 1987, neither instance prompted a legal challenge by the would-be acquiror. The *Polaroid* decision confirmed the prevailing line of cases upholding the issuance of stock to a white squire as a defensive measure when the result was not to consolidate voting control in management or employee hands. Such sales to "friendly" parties should be carefully structured to avoid an unintended subsequent takeover bid by the former "friend." Voting and standstill agreements may be appropriate in this context.

2. Restructuring Defenses

Restructurings have been driven in part by the threat of hostile takeovers. The failure of a company's stock price to reflect fully the value of its various businesses has provided countless opportunities for acquirors to profit handsomely by acquiring a company, breaking it up and selling the separate

pieces for substantially more than was paid for the entire company. Such companies are ripe targets for bust-up takeovers. A primary goal of any restructuring is, therefore, to cause the value of a company's various businesses to be better understood and, ultimately, to be better reflected in its stock price.

Like many forms of takeover defenses, a restructuring is best initiated well before the company is actually faced with a bid. In most cases, a restructuring will only be possible if there has been careful advance preparation by the company and its investment bankers and counsel. Arranging for a friendly buyer of a particular asset, for example, and restructuring a business to accommodate the loss of the asset are time-consuming, costly and complicated endeavors and are difficult to effect in the midst of a takeover battle.

Restructuring defenses have been successfully implemented in a number of prominent transactions. During the course of First Interstate's effort to take over BankAmerica Corporation, BankAmerica announced a corporate restructuring program which involved selling businesses that were not essential to BankAmerica's strategy and reducing its work force. ITT also used this strategy as part of its response to Hilton Hotels Corporation's unsolicited offer for the company.

In addition to asset sales, a stock repurchase plan, such as that pursued by Unitrin in response to American General's unsolicited bid, may be an effective response to a takeover threat. Buybacks at or slightly above the current market price allow stockholders to lock in current market values and reduce the company's available cash, which may be critical to any leveraged acquisition bid. Companies may also initiate such buybacks when they choose not to pursue other publicly announced acquisitions in order to prevent a deterioration in the stock price and/or to reduce vulnerability to unsolicited offers. A principal benefit of stock buybacks is that they may be quickly implemented. The CBS Inc. buyback announced in August 1994, shortly after the company stated that it would not pursue its previously disclosed merger with QVC (which had received an unsolicited offer from Comcast Corporation), is one example of the speed with which a buyback may be implemented following termination of merger discussions.

3. Corporate Spin-Offs and Split-Ups

Target companies have used spin-offs to enhance shareholder values and frustrate hostile acquisition attempts. One means of focusing stock market attention on a company's underlying assets is to place crown-jewel assets in a corporation and sell off some of the shares in an initial public offering. Another means of boosting the share price of a company is to deconglomerate – sell off businesses which no longer fit the company's strategic plans or split the company into logically related units. In either case, a company tries to focus the market's attention on its individual businesses which, viewed separately, may enjoy a higher market valuation than when viewed together.

Institutional pressure has increased on multi-industry companies to spin-off or sell underperforming divisions that sell at low price earnings multiples and are perceived (rightly or wrongly) as dragging down the market valuation of the high-multiple business. Major companies such as AT&T, Baxter, Dun & Bradstreet, Monsanto, W.R. Grace & Co. and numerous others, have undertaken complex spin-offs. Chrysler and RJR Nabisco have been the targets of proxy fights by corporate raiders who have sought to enlist the support of traditional institutional investors. Recent amendments to the tax laws have, however, limited the ability of companies to engage in so-called "Morris Trust" transactions, where a spin-off is followed by a merger involving one of the entities involved in the spin-off. A more complex structure may be required to achieve a valid Morris Trust transaction, although such transactions are still viable, as recently evidenced by the W.R. Grace/Sealed Air Corporation spin-off and merger.

In addition to potentially increasing target company valuations, spin-offs may produce tax consequences that discourage takeover attempts. Commercial Intertech Corp. used this defense to thwart an unsolicited offer by United Dominion Industries. The spin-off of the profitable Cuno Inc. filtration business to CIC shareholders created a "tax poison pill." Had United Dominion acquired either CIC or Cuno following the spin-off, the acquisition could have generated a prohibitive tax liability. A similar technique was employed by ITT in response to the hostile bid by Hilton.

4. Use of an ESOP or SECT as a Takeover Defense

The issuance of common stock to a newly formed ESOP may be a valid response to a hostile offer. In recent years, this response has not been used, although companies with ESOPs already in place may gain support from them when responding to an unsolicited offer. The trust agreement for the ESOP may provide that the unallocated stock will be voted proportionately to the votes cast by employees with respect to the allocated shares and that unallocated shares will be tendered into a tender or exchange offer in the same proportion as allocated shares. The existence of the ESOP makes consummation of a tender offer or a successful proxy fight by a hostile bidder more difficult. It should be noted that the Department of Labor continues to challenge the appropriateness of pass-through voting under ERISA and has had success in litigating this position in the *Polaroid* case. *See Martin* v. *NationsBank of Georgia, N.A.*, C.A. No. 1.92-CV-1474-HTW, 1993 U.S. Dist. LEXIS 6322 (N.D. Ga. Apr. 6, 1993); *summ. judgment denied sub nom.*, *Reich v. Nationsbank of Ga.*, C.A. No. 1:92-CV-1474-HTW, 1995 U.S. Dist. LEXIS 5328 (N.D. Ga. Mar. 29, 1995), *aff'd in part, rev'd in part, and remanded sub nom. Herman* v. *NationsBank Trust Co. (Ga.)*, 126 F.3d 1354 (11th Cir. 1997). Although there is not yet a definitive resolution of these issues, the Department of Labor has taken the position that (i) the decision whether to tender or how to vote shares is a fiduciary decision that ultimately must be made by the plan trustee in the best interests of plan participants, which may require the plan to disregard any participant directions that are imprudent, and (ii) in determining the best interests of plan participants, *only* their economic interests in the retirement plan may be considered by the plan trustee, who may not consider whether active participants may otherwise suffer from the takeover, such as through job loss. *See* Labor Reg. § 2509.94-2, 29 C.F.R. Pt. 2509 (Interpretive Bulletin relating to written statements of investment policy, including proxy voting policy or guidelines).

More recently, the DOL has articulated a position that imposes a different legal standard with respect to participant directions regarding shares allocated to their accounts than for allocated shares as to which no participant directions are

received and unallocated shares. See *Herman,* 126 F.3d 1354. In that case, the DOL reiterated its view that an ESOP trustee may follow participant instructions as to allocated shares unless to do so would be imprudent, on the theory that the participants are the "named fiduciaries" as to the shares in their own accounts and the trustee therefore acts as a directed trustee. However, the DOL took the position that participants cannot be treated as named fiduciaries with respect to uninstructed and unallocated shares. The Eleventh Circuit decided the case on the narrower basis that even if participants could in theory be named fiduciaries as to uninstructed and unallocated shares, they would have to be put on notice of their fiduciary status, and no such notice had been given in the case at hand. However, the court cast doubt upon whether even giving notice would be sufficient, suggesting that participants could not be forced into fiduciary status without their consent. The court expressed concern about the potential for participants to be sued by other participants for fiduciary breaches, a concern that does not arise where participants act as named fiduciaries only as to shares allocated to their own accounts. If participants are not named fiduciaries as to unallocated and uninstructed shares, then the trustee has a higher level of responsibility in determining whether to follow a mirror voting provision.

A Stock Employee Compensation Trust ("SECT") is a grantor trust similar to a leveraged ESOP, although with certain tax and accounting advantages. It may provide some support in the context of an unsolicited offer. A company implementing a SECT establishes a trust with a relatively long fixed term (*e.g.*, 10 to 15 years) which holds shares of stock to be used to fund the company's obligations during the term of the trust in respect of certain of the company's benefit plans. The company issues shares of its common stock to the SECT in exchange for a note from the SECT. The SECT then releases shares of the common stock over the life of the trust as the note is paid down through contributions by the company, to satisfy certain benefit requirements under the benefit plans.

The SECT is not subject to ERISA and, although it is regarded as an integral part of the company for federal income tax purposes (resulting in compensation deductions for tax purposes based on the actual market value of the stock released from the trust), is considered a separate entity for corporate law

purposes. The shares in the SECT are treated as outstanding shares and are voted by the SECT trustee on a pass-through basis at the direction of benefit plan participants.

As is customary for most ESOPs, decisions with respect to the voting and tendering of shares in the SECT are directed by employee participants. However, because the SECT is not subject to ERISA, it is not subject to the potential Department of Labor restrictions described above. Therefore, subject to the trustee's fiduciary obligations, shares held in the SECT may more easily be used to oppose an unsolicited offer or proxy contest. A SECT was used by The Hillhaven Corporation following a takeover offer from Horizon Healthcare Corporation. In addition, as with a rabbi trust, a SECT may also be used to protect employee interests in benefit plans that are not subject to ERISA in the event of a change in control transaction.

5. Regulatory Action

In addition to antitrust regulation, which may itself provide an important ground for disputing the feasibility of a hostile offer, many companies are subject to other regulatory authorities that must approve a change of control. In industries such as telecommunications and banking, federal (and sometimes state) regulators may be receptive to arguments made on behalf of the target (or by the target itself) maintaining that a merger is not consistent with the policies and practices of the relevant agency. A company subject to such regulation may take full advantage of any rights it may have to file protests and comments with such agencies. However, in view of the ongoing oversight of such agencies and the importance of maintaining strong relationships with the regulators, companies must avoid filing dilatory or frivolous comments. Regulators who conclude that a company is acting in bad faith will be unsympathetic to other objections; nonsubstantive comments may provoke an undesired regulatory response. Concerns regarding antitrust, financing, management resources and relevant public policy interests may properly be brought to the attention of regulators.

As with other defensive responses, a seller already committed to one transaction must be careful in responding to

the third-party bid with regulatory objections, since regulatory issues relating to one offer may well be applicable to the preferred merger partner's bid.

V

Pricing and Structural Issues in Business Combinations

The continued enthusiasm for stock-swap mergers raises difficult pricing and market risk issues. All-cash offers too can be impeded by substantial changes in market prices. Even if the parties come to an agreement on the relative value of the two companies, the value of the consideration may be dramatically altered by market-wide trends, such as a substantial decline in financial markets, industry-specific market trends and company-specific market performance, or any combination of the foregoing. Although nominal market value is not the required legal criterion for assigning value to stock consideration in a proposed merger, a seller in a transaction that is not a true merger of equals may have great difficulty in obtaining stockholder approval of a deal whose nominal market value is less than, or only marginally greater than, the current market value of the seller's stock.

As recent market volatility has reflected, the potential impact of market factors adds further complexity to the typical M&A negotiation, since a merger proposal that becomes public carries substantial market risk for the buyer, whose stock may fall precipitously because of anticipated dilution or the financial impact of the transaction, which in turn may put pressure on the buyer to offer additional make-whole consideration, exacerbating the dilutive effect of the deal, or to abandon the transaction. This Part discusses the key structural and pricing decisions that must be faced in all-stock or cash-stock hybrid transactions, some of which are also relevant in the context of an all-cash deal.

A. Factors Influencing Choice of Structure

1. Tax Considerations

As a result of both an acquiror's need to conserve capital and the desire of the shareholders of the target to have the opportunity for tax deferral, most mergers are structured as tax-free stock-for-stock transactions. There are generally three forms of transaction in which tax-free treatment can be achieved for shareholders who exchange their stock in the target company ("Target") for stock in the acquiring company ("Acquiror").

a. Direct Merger

Target merges with and into Acquiror, or *vice versa*. This will generally be nontaxable to Target, Acquiror and Target's shareholders who receive only stock of the surviving corporation, provided that stock constitutes at least 50% of the total consideration. The 50% limitation on the amount of cash in a transaction is an Internal Revenue Service safe harbor, and most counsel will issue tax opinions where up to 55% of the consideration is cash. For these purposes, stock includes voting and nonvoting stock, both common and preferred. Target shareholders will be taxed on the receipt of any cash or "other property" in an amount equal to the lesser of (x) the amount of cash or other property received and (y) the amount of gain realized in the exchange, *i.e.*, the excess of the total value of the consideration received over the shareholder's adjusted tax basis in the Target stock surrendered. For this purpose, "other property" includes preferred stock ("Nonqualified Preferred Stock") that does not participate in corporate growth to any significant extent and (i) is puttable by the holder within 20 years, (ii) is subject to mandatory redemption within 20 years, (iii) is callable by the issuer within 20 years and is more likely than not to be called or (iv) pays a variable rate dividend, unless the Acquiror Nonqualified Preferred Stock is received in exchange for Target Nonqualified Preferred Stock. Any gain recognized will generally be capital gain, although it can under certain circumstances be taxed as dividend income.

b. Forward Triangular Merger

Target merges with and into an at least 80% owned (and usually wholly owned) direct subsidiary of Acquiror ("Merger Sub"). The requirements for tax-free treatment and the taxation of non-stock consideration (including Nonqualified Preferred Stock) are the same as with a direct merger. However, in order for the merger to be tax-free, there are two additional requirements. First, no stock of Merger Sub can be issued in the transaction. Thus, preferred stock of Target may not be assumed in the merger but must be reissued at the Acquiror level or redeemed prior to the merger. In addition, this requirement raises certain technical issues in circumstances in which Acquiror already owns Target stock. Second, Merger Sub must acquire "substantially all" of the assets of Target, generally 90% of net assets and 70% of gross assets. This requirement must be taken into account when considering asset dispositions or spin-offs soon after a merger or redemption of Target stock prior to the merger.

c. Reverse Triangular Merger

Merger Sub merges with and into Target. In order for this transaction to be tax free, Acquiror must acquire at least 80% of all of Target's voting stock and 80% of every other class of Target stock for its voting stock. Thus, nonvoting preferred stock of Target must either be exchanged for Acquiror voting stock or redeemed prior to the merger. In addition, Target must retain substantially all of its assets after the merger.

d. Section 351 Transaction

An alternative, less frequently used structure is for both Acquiror and Target to be acquired by a new holding company, Holdco, under Section 351 of the Internal Revenue Code. As a corporate matter, this would be achieved by Holdco creating two subsidiaries, one of which would merge with Acquiror and the other with Target in two simultaneous reverse triangular mergers. Shareholders of Acquiror and Target would receive tax free treatment to the extent that they received Holdco stock, which may be common or preferred (other than Non-qualified

Preferred Stock), voting or nonvoting, provided that the shareholders of Acquiror and Target own at least 80% of the voting stock and 80% of each other class of stock of Holdco immediately after the transaction. Unlike the other forms of transactions, there is no limit on the amount of cash that may be used in the transaction as long as the 80% ownership test described above is satisfied. Cash and Nonqualified Preferred Stock received will be taxable up to the amount of gain realized in the transaction.

2. Accounting Issues: Purchase and Pooling

The parties to a merger will need to decide whether to structure it, for accounting purposes, as a purchase of one institution by the other or as a pooling of interests of the two institutions. The pooling-of-interests accounting method assumes that the combining companies have been merged from their inception, and their balance sheets are simply added together with no additional goodwill created. Under purchase accounting, the excess of the value of the stock issued, and other consideration paid, over the fair value of the assets acquired is recorded as goodwill. The creation of this goodwill results in an immediate deterioration of the combined companies' key capital ratios, and the amortization of goodwill produces a long-term drag on earnings. In many cases, particularly where the acquisition is large, from the acquiror's perspective, these effects are so severe that, as a practical matter, they rule out a purchase and make a pooling transaction mandatory. A noteworthy exception to this general rule was the 1991 acquisition of Security Pacific by BankAmerica, which was intentionally structured as a purchase so that BankAmerica could write down Security Pacific's assets upon consummation. BankAmerica concluded that this ability, which would result in avoidance of the future draft of the related assets on earnings, more than offset the cost of amortizing any goodwill created in the transaction.

a. Pooling of Interests Accounting

The importance of pooling to certain transactions, particularly the large transactions in the financial institutions industry (Travelers/CitiCorp, NationsBank/BankAmerica and

Banc One/First Chicago) and in the industrial sector (BP/Amoco), is evident. Indeed, in 1998, the total value of bank mergers accounted for as poolings was $257.6 billion, while purchase deals totaled only $19.6 billion. There may be substantial benefits to pooling of interests accounting for a particular transaction. The benefits include avoiding a "mark to market" of the seller's assets and the earnings drag of goodwill. The requirements for pooling qualification are complex and highly fact-specific; incidental transactions shortly before or after a merger may harm the ability to treat the transaction as a pooling for accounting purposes. As the requirements summarized below reflect, pooling demands raise numerous structural considerations.

Opinion No. 16 of the Accounting Standards Board sets forth the requirements for a pooling. In order for a combination to be treated as a pooling, all of the following conditions must exist:

- *Common stock must be used*. The consideration paid must be only common stock with rights identical to those of the majority of the outstanding voting common stock of the issuing corporation, and such stock must be offered and issued in exchange for substantially all of the voting common stock interest of the other company at the date the plan of combination is consummated.

- *Equity interests may not be changed in contemplation of the transaction*. Neither of the combining companies may change the equity interest of its voting common stock, whether by making distributions to stockholders, by making additional issuances, exchanges and retirements of securities or otherwise, or by amending stock-based incentive plans, in contemplation of effecting the combination either within two years before the plan of combination is initiated or between the dates the combination is initiated and consummated.

- *No extraordinary acquisitions of treasury stock are permitted.* Neither of the combining companies may reacquire shares of voting stock except for purposes other than business combinations, and neither company may reacquire more than a normal number of shares between the dates the plan of combination is initiated and consummated.

- *Stockholders' proportionate interests may not be changed.* The ratio of the interest of each individual common stockholder to those of other common stockholders in each combining company must remain the same as a result of the exchange of stock to effect the combination.

- *Shareholders' voting rights may not be limited.* The voting rights to which the common stock ownership interests in the resulting combined corporation are entitled must be exercisable by the stockholders. Stockholders may not be deprived or restricted in exercise, of those rights.

- *The combining companies must be autonomous.* Each of the combining companies must be autonomous and must not have been a subsidiary or division of any other company within two years before the plan of combination is initiated.

- *The combining companies must be independent.* Each of the combining companies must be independent of the other.

- *There is a one year time limit for accomplishing the transaction.* The combination must be effected in a single transaction or be completed in accordance with a specific plan within one year after the plan is initiated.

- *Contingent payments are prohibited.* The combination must be resolved at the date the plan is consummated and no provisions of the

plan relating to the issue of securities or consideration may be pending.

- *No post-merger acquisitions of common stock may be planned*. The combined company may not agree directly or indirectly to retire or reacquire all or part of the common stock issued to effect the combination.

- *No post-merger arrangements for former stockholders may be pending*. The combined company may not enter into other financial arrangements for the benefit of the former stockholders of either combining company, such as a guaranty of loans secured by stock issued in the combination, which in effect negates the exchange of equity securities.

- *Post-merger dispositions of property are limited*. The combined company must not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the combination, other than disposals in the ordinary course of business of the formerly separate companies and to eliminate duplicate facilities or excess capacity.

As this extensive list of requirements makes clear, the requirements for pooling treatment are strict. Any of a number of seemingly innocuous transactions or agreements, such as repurchasing stock, paying an unusual cash dividend or issuing a new class of voting stock, can result in pooling treatment becoming unavailable. Accordingly, when pooling treatment is desired, all aspects of the proposed transaction must be considered with the requirements of APB No. 16 in mind. The complexities of the pooling rules make a hostile pooling transaction difficult to complete.

Despite the importance of pooling transactions to certain mergers, pooling-of-interests accounting is increasingly under attack from accounting rule makers. The SEC has generally increased its scrutiny of pooling and has already taken actions that limit a company's flexibility in poolings, particularly

in the case of share buybacks (discussed below). It recently required U.S. Products Co. and Corporate Express, Inc. to restate their stock-financed acquisitions as purchase, rather than pooling, accounting, due in part to those companies' stock buybacks. Moreover, the Financial Accounting Standards Board recently invited comment on a recommendation to harmonize international accounting practices in business combinations by abolishing pooling altogether and instead permitting only purchase accounting. *See Invitation to Comment, Methods for Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence*, FAS No. 192-A (December 15, 1998). Even if this recommendation is not adopted or is delayed, the SEC may still decide through Regulation S-X to block pooling treatment in transactions in which registered stock is being issued.

b. New SEC Guidelines on Buybacks and Poolings

In March 1996, the SEC staff released a new accounting bulletin (SAB No. 96) setting forth staff interpretive advice on four current issues involving stock buybacks following poolings of interests. In recent years many companies (especially telecommunications companies, companies with excess cash received in connection with a spin-off and banks and other financial institutions) have been increasingly active not only in repurchasing shares but also in expanding the scope of announced buyback programs for the next year.

The SEC release emphasizes the key lesson of recent aggressive SEC scrutiny of announced pooling mergers – an intention to buy back shares following a business combination will preclude pooling accounting treatment unless the number of tainted shares reacquired within two years of the transaction remains below the 90% test in APB 16. The SAB does not affect current rules permitting shares to be bought back without being subject to a "taint" if they are acquired in a seasoned "systematic pattern of reacquisition" for reissuance pursuant to employee stock options and the like.

Under the SAB, even the resumption of buybacks pursuant to a preexisting plan would be subject to the two-year

rule if the resumption were planned in connection with a pooling. This interpretive position is based on the staff's belief that an intention to resume a program "cannot be distinguished" from a deal-related intention to buy back shares.

The SAB also announced the reversal of a long-standing informal policy of the SEC staff that buybacks occurring at least 90 days after a pooling transaction would not in themselves give rise to the presumption that they were planned at the time of the pooling. That informal policy was based on the SEC's 1974 Accounting Series Release No. 146A, which cautioned that "the substance of reacquisitions *closely* following consummation" of a pooling "should not be ignored." 1974 SEC LEXIS 3330 at *4 (emphasis added). The staff's new policy is that any buybacks – or *announcements* of *intended* buybacks – that occur less than *six months* following a pooling will "provide persuasive evidence of a prior intention" and therefore "taint" the shares bought back with respect to the past pooling. 1996 SEC LEXIS 743 at *6. Under existing SEC policy, the shares would also be tainted for future poolings.

Buybacks after six months will not be questioned by the staff where there is "no evidence" buybacks were planned at the time of the pooling. Examples of evidence of planned buybacks given in the SAB include pre-closing announcements regarding future buybacks, decisions by authorized corporate officials to reacquire shares, and the "use of projections or forecasts" reflecting post-closing buybacks. *Id.*, at *5, n.3. Companies frequently prepare alternative sets of projections with different capital assumptions, and the greatest scrutiny can be expected for projections that are publicly disclosed or discussed with analysts in connection with a merger. Still, care should be taken to document that even internal, informational forecasts do not necessarily reflect a company's plans or intentions.

The six-month look back on buybacks is not a flat rule, and the facts and circumstances in a given instance may permit a company to demonstrate that post-pooling buybacks were not planned. For example, an unexpected "bear hug" or other hostile takeover attempt, and perhaps even a "market break" of the sort that occurred in October 1987, may permit the initiation of a new buyback program without calling into question a past pooling. Where a past pooling was relatively

small, the presumption that large post-closing buybacks were planned at the time of the pooling should be easier to overcome.

In 1997, the SEC continued its close scrutiny of share buybacks in the context of proposed pooling transactions. It was common in the context of the SEC comment period on a Form S-4 registration statement for the accounting staff to request a detailed spreadsheet of all share repurchases and reissuances during the two year period prior to the proposed transaction. In particular, the staff has set the bar very high for meeting the requirements of a "systematic pattern of reacquisition" for reissuance pursuant to employee stock options and the like.

c. Push Down Accounting

Another accounting technique that sometimes has a significant effect on mergers accounted for by the purchase method is the use of push down accounting. Push down accounting is the establishment of a new basis of accounting in the separate financial statements of a subsidiary company as a result of a change of control. Under push down accounting, when a company is acquired by a purchase or a series of purchases, yet retains its separate corporate existence, the assets and liabilities of the acquired company are restated to their fair values as of the acquisition date. These values, including any goodwill, are reflected in the separate financial statements of the acquired company as well as in any consolidated financial statements of the company's parent.

3. Other Factors

In addition to the tax and accounting issues that are central to any major corporate transaction, deal structure will be influenced by corporate and securities law considerations common to all mergers and acquisitions as well as by general regulatory (such as antitrust) and industry-specific regulatory (such as FCC rules and Federal Reserve Board rules, as applicable) concerns. Alternative structures are sometimes designed to address concerns about state law shareholder approval requirements or to avoid class votes by certain classes of securityholders. While triangular mergers often reduce the need to seek debtholder or other third-party approvals, they

may be considered to be cosmetically undesirable in certain circumstances where a transaction is being touted as a merger of equals. Structural considerations can also affect which state and federal regulatory approvals will be required.

The choice of structure may be influenced by tax and other considerations that are important to large or controlling shareholders. The Ninth Circuit decision in *Epstein* v. *MCA, Inc.*, 50 F.3d 644 (9th Cir. 1995), *rev'd on other grounds*, 516 U.S. 367 (1996), calls into question the well-known form of acquisition that involves a cash tender offer for most of a company's common stock combined with a recapitalization that permits certain shareholders to convert their common stock into preferred stock on a tax-free basis – referred to as a "National Starch" transaction structure. The agreement for the recapitalization is entered into prior to the tender offer and closes after the tender offer. This form of acquisition is designed to accommodate an older shareholder who does not want to realize a capital gain, preferring to postpone a sale and allow his shares to pass to his estate with a stepped-up basis. In a decision that rejects the widely held view that SEC Rule 14d-10 applies only during the actual tender offer period, the *MCA* court held that the Rule 14d-10 requirements that a tender offer be open to all holders, and that every shareholder receive the highest price, is violated by the usual National Starch type transaction. The SEC did not raise any Rule 14d-10 issues in connection with the MCA-Matsushita transaction when it was effected in 1990. However, in light of the Ninth Circuit decision, the National Starch type transaction is questionable unless and until the law is clarified. Other circuits have adopted a contrary reading of Rule 14d-10, limiting its applicability to the tender offer period. *See*, *e.g.*, *Lerro* v. *The Quaker Oats Company*, 84 F.3d 239, 243 (7th Cir. 1996) (citing cases).

B. Timing

Exposure to market risk for both the acquiror and the target is only magnified by the possibly protracted time period between agreement on the terms of the deal, stockholder approval and consummation. The length of delay is usually driven by SEC requirements for the registration and proxy statement or for tender offers. Even if the registration statement can be prepared soon after signing of the merger

agreement, and even if the registration statement raises few or no comments from the SEC, at least 20 days will lapse between filing of the registration statement and dissemination to shareholders. A realistic time frame for deal completion from signing to closing is at least 90 days. This estimate, of course, assumes that other conditions and regulatory review requirements can be satisfied in that period, an assumption that will often prove unrealistic, particularly in the case of mergers requiring regulatory approvals which may take six months or more to complete.

Tender offers may generally be consummated more quickly, subject only to a minimum of 20 business days from commencement (assuming no extensions based on SEC comments or conditions to closing the transaction). Current SEC regulations can subject stock tender offers to greater delay. Tender offers with stock as consideration must await SEC review before the 20-day time period starts running. All-cash offers, however, commence upon filing, providing a distinct timing advantage over stock tender offers. Recently proposed rules, however, would place stock and cash tender offers on a more equal regulatory footing by permitting stock tender offers to commence upon filing of a registration statement. See Proposed Rule: Regulation of Takeovers and Security Holder Communications, SEC Release Nos. 33-7607; 34-40633; IC-23520 (November 3, 1998).

The time period between agreement and consummation poses risks for seller and buyer. Seller may, for example, receive third-party offers with a nominal market value substantially greater than that of the preferred merger partner's bid; buyer may be obligated either to top the third party's bid or to compensate the seller's stockholders for the decline in market value between announcement and closing. If the deal collapses due to market decline or competing bidders, the seller's stock may require a substantial period of time before it returns to pre-merger values.

These concerns and the inherently fluctuating value of stock consideration require both seller and buyer to think carefully about the allocation of market risk and provide for such allocation in the definitive documentation.

C. All-Cash Transactions

Although the popularity of stock as a form of consideration has risen dramatically in recent years and continues to be the dominant form of consideration in the current environment, all-cash offers remain appealing whenever pooling-of-interests accounting is not required and other factors, including tax considerations, do not counsel otherwise. Particularly in the case of an unsolicited offer, all-cash bids have the benefit of being of certain value and will gain quick attention from the target's stockholders. The value of a cash offer does not fluctuate with market prices. In addition, the buyer's stock price should be less adversely affected than in the case of an all-stock offer because of the avoidance of dilution.

Of course, many bidders do not have sufficient cash and financing sources to pursue an all-cash transaction. In such cases, the relative benefits and complexities of part-cash/part-stock and all-stock transactions must be considered.

D. Pricing Formulae and Allocation of Market Risk in Stock Transactions

The time factor and the market volatility factor inherent in any stock-for-stock merger means that the typical stock merger is subject to market risks over a lengthy period of time. A drop in the price of an acquiror's stock between execution of the acquisition agreement and the closing of the transaction results in the seller's shareholders receiving less value for their exchanged shares (or increases the transaction's potentially dilutive effect on the acquiror's shares). Such market risk can be dealt with by a pricing structure that uses a valuation formula instead of a fixed exchange ratio and, frequently, a collar. In addition to, or in lieu of, a collar pricing mechanism, transactions have also included so-called "walk-away" provisions permitting unilateral termination in the event the acquiror's share price falls below a certain level (either on an absolute or an indexed basis).

1. Fixed Exchange Ratio

The simplest pricing structure in a stock-for-stock transaction is to set a fixed exchange ratio at the time an

agreement is signed. The advantage of a fixed exchange ratio for the acquiror is that it is able to determine at the outset how much stock it will have to issue (and thus can determine the impact on per-share earnings with some certainty). On the other hand, a decline in the market value of the acquiror's stock and the accompanying decline in the value that the seller's stockholders will receive at closing could jeopardize stockholder approval and/or invite third-party competition. From the acquiror's perspective, these are generally risks that can be dealt with if and when they arise, and the acquiror typically prefers the certainty of a fixed number of shares.

With a fixed exchange ratio, the seller's stockholders, if they choose to hold their stock until the closing, bear both general market risk and specific risk associated with the acquiror's stock. Of course, to the extent the acquiror and seller are in the same industry, industry-wide changes would, presumably, affect their stock prices equally. A fixed exchange ratio is frequently used in merger of equals transactions.

The fixed exchange ratio is also the most common (but far from exclusive) pricing alternative in transactions with a larger aggregate dollar value. This may be due in part to the fact that large public companies typically have actively traded stocks, and the acquiror may persuasively argue that the market will soon reflect the value of the merged company. A fixed exchange ratio promotes maximum risk sharing between the two stockholder groups.

The fixed exchange ratio continues to be the dominant form of stock-for-stock merger transaction, including during the current year. Companies that are parties to pending strategic mergers in which the nominal market value of the consideration to their shareholders has significantly declined in recent months have successfully defended their deals based on the long-term strategic prospects of the combining companies. This strategic imperative is especially evident in merger of equals transactions.

2. Fixed Value with Floating Exchange Ratio; Collars

In many situations, the seller and/or the acquiror will be unwilling to leave the nominal value of the consideration at the

time it is to be paid dependent upon market fluctuation. Whether to provide for the seller's stockholders to receive a fixed value in stock through the use of a floating exchange ratio and/or a price collar (discussed below) will depend, among other things, on the parties' expectations as to market performance as well as the anticipated delay in consummating the transaction.

A floating exchange ratio sets the exchange ratio based on an average market price for the acquiror's security during some period, normally 10 to 30 trading days, prior to closing or the date of the seller's stockholder meeting to approve the transaction. Thus, the acquiror would agree to deliver a fixed value (*e.g.*, $30) in stock for each of the seller's shares, with the number of acquiror's shares to be delivered based on the market price during the specified period. The acquiror bears the market risk of a decline in the price of its stock since, in such event, it will have to issue more shares to deliver the agreed value. Correspondingly, the acquiror may benefit from an increase in the price of its stock since it will be required to deliver fewer shares to provide the agreed value. The seller's stockholders bear little market risk in this scenario and correspondingly will not benefit from an increase in stock prices since the per share value is fixed. Because, as the transaction becomes more likely and approaches fruition, the acquiror's stock may fall due to the anticipated dilution, the acquiror can be expected to argue for an earlier valuation period, while the seller may claim that the market price over some period immediately prior to consummation provides a better measure of consideration received.

A floating exchange ratio based upon the acquiror's stock price during a pre-closing period, while protecting the seller's stockholders against price declines, exposes the acquiror to the possibility of massive dilution, limited only by the amount by which the stock price can decline. In this regard, issuers must be cognizant of the fact that the price of their stock may decline precipitously based on events or circumstances having little or nothing to do with the fortunes of the issuer and that such declines for any reason may be only short-lived. To protect against such dilution, agreements with floating exchange ratios frequently place a cap on the maximum number of shares to be issued and, at the same time, place a floor on the minimum

number of shares that may be issued. Such agreements provide, in effect, both upper and lower market price limits within which the number of shares to be delivered will be adjusted. If market prices go outside the range, no further adjustments are made. Obviously, the size of the range determines the degree of protection afforded to, and the amount of the risk borne by, the seller's stockholders and the acquiror.

In today's market environment, in which stock mergers dominate and market volatility cannot be predicted, issuers must carefully consider the possibility of dramatic market events between signing and closing. Although fixed value transactions typically include a collar or other limit on the total shares to be issued, in Cendant's acquisition of American Bankers Insurance Group, the transaction terms included only a fixed dollar value, in a part-stock, part-cash offer, with no collar, floor or other conventional pricing formula. While the merger was pending, Cendant announced certain accounting irregularities which caused its stock to drop more than 40% in a single week, thus exposing Cendant shareholders to significant additional dilution in the pending merger. As a consequence of the drop in Cendant's stock and the open-ended fixed-value formula, Cendant became obligated to acquire one-half of American Bankers for nearly twice as many shares as intended at the time the deal was announced.

3. Fixed Exchange Ratio within Price Collar

Another formulation that may appeal to a seller who is willing to accept some risk of a preclosing market price decline in an acquiror's stock, but wishes to protect against declines beyond a certain point, combines elements of the two formulations described above. In this formulation, the seller's stockholders are entitled to receive a fixed number of shares of acquiror stock in exchange for each of their shares, and there is no adjustment in that number as long as the acquiror's stock is valued within a specified range during the valuation period (*e.g.*, 10% above or below the price on the date the parties agree to the exchange ratio). If, however, the acquiror's stock is valued outside that range during the valuation period, there is an adjustment in the number of shares to be delivered similar to the adjustment described in subsection 2. Thus, for example, if the parties agree on a one-for-one exchange ratio and value the

acquiror's stock at $30 for purposes of the transaction, they might agree that price movements in the acquiror's stock between $27 and $33 would not result in any adjustments. If, however, the stock is valued at $25 during the valuation period, the number of shares to be delivered in exchange for each seller share would be 1.08, *i.e.*, a number of shares equal to $27 based on the $25 valuation.

For the same reasons referred to in subsection 2, the acquiror would want to put limits on the maximum number of shares it would have to deliver, and the seller would want to set a minimum number of shares its stockholders would receive. The acquiror would argue that the seller's stockholders should bear some of the risk of a price decline, and the seller would argue that its stockholders, if they are to bear risk of price declines, should receive the benefits from a price increase.

E. Walk-Aways

In a number of recent transactions, the parties have also included conditions to closing that give the seller the right to walk away from the merger if the price of the acquiror's stock falls below a certain level. For example, a fixed exchange ratio walk-away provision would permit termination of a merger agreement by the seller if, at the time the transaction is to close, the acquiror's stock has decreased by 15% (a "single trigger"). Some walk-away formulae require a double trigger. These walk-aways always apply only if there is an absolute agreed-upon percentage decline in the acquiror's stock price and a specified percentage decline in the acquiror's stock price relating to a defined peer group of selected companies during the pricing period. The double trigger essentially limits the walk-away right to market price declines specifically related to the acquiring company. Walk-away rights are generally tested during a short trading period prior to closing and often include an option for the acquiror to elect to increase the exchange ratio to avoid triggering that target board's walk-away right.

Similarly, an acquiror entering into a transaction with a floating exchange ratio, or with a fixed ratio within a price collar but without a cap on the number of shares it must issue, may negotiate for a termination right if its stock falls below a specified level, thus requiring it to issue more than a specified

number of additional shares in order to provide the agreed consideration. In such a case, the seller should negotiate for the right to waive, so that if the acquiror has to issue more than the specified number of additional shares, the seller may waive the requirement for additional consideration and the acquiror remains obligated to consummate the merger.

Walk-away rights are not common. Although walk-aways may appear desirable at first glance, they create additional risks that a transaction that appears desirable from a business and strategic point of view will not be consummated due to temporary market fluctuations. Moreover, the necessity for stockholder approval inherent in most stock-for-stock transactions provides a *de facto* walk-away right for price declines existing at the time of the vote, assuming, of course, that such declines are sufficiently large to defeat stockholder approval.

Stock market declines in recent months have caused some deals with floating exchange ratios or price collars to fall into the range in which one party has a walk-away option, including in some cases within a few weeks of announcement of the transaction. Such events can cause substantial difficulty in the planning of the post-merger combined company, since most walk-away rights relating to stock price declines are only triggered during a short period immediately prior to closing. Even the double-trigger walk-away, which attempts to correct for broad-based market declines, is imperfect, since there is no precise measure of the relative performance of the combining companies' securities during the period between signing and closing.

In such circumstances, companies may prefer to rely on more customary "walk-away" rights, such as the absence of a material adverse change in the other party's business, operations and financial condition prior to closing. Shareholder approval, required for most mergers, particularly in this period of large strategic combinations, generally continues to be the most effective means of ensuring that the negotiated deal, including its price, remains in the best interests of each party's shareholders. The benefits of the walk-away, and the related components of a floating exchange ratio or a price collar, must be carefully weighed against the potentially significant costs of

deal uncertainty and the risk of non-consummation after months of planning for the combined company.

F. Fiduciary Duties and Price Decline

In addition to the walk-away right, the fiduciary duties owed by the seller's board to its stockholders may provide a variety of walk-aways. Most stock-for-stock transactions require the seller's stockholders' approval, and the acquiror usually receives a contractual provision obligating the seller's board to recommend the transaction to its stockholders. Whether by explicit language or operation of state corporate law, that obligation is limited by the board's fiduciary duties, in particular the duty of candor. In the case of a sharp decline in the value of the consideration offered, whether because of a decline in the stock price or other event affecting the company's future, the seller's board may effectively create a surrogate for the walk-away if it concludes that it cannot, consistent with its fiduciary duties, recommend the transaction to stockholders.

G. Derivative Securities and Market Risk: Post-Closing Value Assurance

An alternative to floating exchange ratios, which look to market price prior to the closing, is the so-called contingent value right ("CVR"). A relatively recent feature of stock-for-stock transactions, the CVR provides some value assurance to the seller's stockholders by giving them a security whose primary feature is the right to compensation in the event that the seller's stock trades below some specified price during a set period after the closing. CVRs may be payable, at the acquiring company's option, in cash, securities or debt, and they may have optional extension periods, pursuant to which the company may roll over the securities for an additional period in exchange for an increase in the price protection offered.

As indicated above, a CVR provides that, if the market price over some average trading period (*e.g.*, at the first anniversary of the merger) is below a fixed price, the acquiror will compensate the CVR holder up to a set amount. For example, a CVR for a security that has a $40 market value at the time of the transaction might provide that if, on the first anniversary, the average market price over the preceding one-

month period is less than $38, the CVR holder will be entitled to cash, equity or debt with a fair market value to compensate for the difference between the then-average trading price and $38. The CVR may have a lower limit, *e.g.*, $33, so that if the average market price at the measuring period is below $33, the CVR holder will be entitled to no more than $5 in price protection, thereby protecting the acquiror against dilution in the same manner that a collar or cap does in the case of floating exchange ratios. The CVR may be extendable for one or two years or another specified period, at the acquiror's option, with the acquiror increasing the price protection by, for example, increasing the protection range to $33-40 in the second year and $33-43 in the third year. The CVR was used by Viacom in its successful bid for Paramount.

The CVR has features that an acquiror may find preferable to a collar. It allows the stock price to recover from any initial downward movement based on announcement of the acquisition. Both the method and the time of payment are flexible, which may help prevent dilution. If the acquiror believes its stock price will substantially improve over the near term, and that belief is borne out, issuing the CVR is essentially costless. On the other hand, a post-closing malaise in the acquiror's stock price may be due, in part if not entirely, to poorer-than-expected performance by the seller and/or to the absence of anticipated synergies. In such an event, the acquiror, through the CVR, is simply paying more for an acquisition after the acquiror knows it has failed, a prospect that might be unattractive.

H. Finding the Appropriate Pricing Structure

The pricing structure used in a particular transaction (and thus the allocation of market risk between the acquiror and the seller and their respective stockholders) will depend on the characteristics of the deal and the relative bargaining strength of the parties. A pricing structure used for one deal may, for a variety of reasons, be entirely inappropriate for another. For instance, the pricing formula in a transaction involving entities of significantly different size, one of which is clearly the acquiror, could be quite different from that employed in a merger of equals or similar transaction, where the stockholders

of each entity are being given the opportunity to participate, over the longer term, in a new partnership.

The determination whether to negotiate for collar pricing or another price protection device will depend on various factors, including the parties' views on the potentially dilutive effect of an issuance, the overall prospects for the stock market in the relevant industry, the relative size of the two companies, the parties' subjective market expectations over time and the desirability or necessity of pegging the transaction price to a cash value.

The acquiror must also consider the anticipated effect on its stock price of shorting by arbitrageurs once the deal is announced. In some mergers, pricing formulas and collars are considered inadvisable due to the potential downward pressure on an acquiror's stock as a result of arbitrage trading.

In a situation which is a pure sale, a seller might legitimately request the inclusion of protective provisions such as a floating exchange ratio and/or a walk-away. This is especially so if the seller has other significant strategic opportunities available to it. An acquiror will argue, of course, that the seller should not be entitled to absolute protection (in the form of a walk-away) from general market (compared to acquiror-specific) risk. That is, if the acquiror's stock does no more than follow a general market trend, there should be no right on the part of the seller to "walk." A "double trigger" walk-away can correct for general market or industry-wide events. For example, the double-trigger walk-away may require that the acquiror's average stock price prior to closing fall (i) 15% or 20% from its price at the time of announcement, and (ii) 15% or 20% relative to a defined peer group of selected stocks.

At the other end of the spectrum, in the merger of equals or "partnership" type of transaction, claims on the part of the seller for price protection, especially walk-aways, are less firmly based. The argument for some price protection is that, once the deal is signed, the seller's shareholders are (and should be) participants in both the opportunities and the risks of the new enterprise. Moreover, in both this type of transaction and a true acquisition, the seller can always find some comfort,

albeit less direct, in respect of acquiror-specific price risk in the representations on the part of the acquiror relating to the nonoccurrence of material adverse changes and other warranties (the accuracy of which will be a condition to closing).

Because of the length of time required to complete some strategic acquisitions such as bank or telecommunications mergers, and the fact that they are generally stock-for-stock transactions, the management of, or protection against, market risk through various price-related provisions can assume particular significance during deal negotiations. Blind adherence to precedent without an analysis of the particulars of the transaction at hand can be disastrous, as can careless experimentation. Deal participants should carefully consider the many alternative pricing structures available in light of the parties' goals and the various risks involved.

I. Hybrid Transactions: Stock and Cash

Although part-cash transactions eliminate the possibility of accounting for a business combination as a pooling of interests, and thus may give rise to substantial goodwill, acquirors with excess capital and/or in situations where the goodwill is not prohibitive may wish to employ both stock and cash as consideration. Moreover, depending upon the characteristics of the parties, including the amount, if any, of goodwill that might be created, utilizing cash as part of the merger consideration may actually reduce the dilutive effect of the merger.

Sellers may find mixed consideration desirable because the cash component provides some downside protection to sellers from a decline in the price of the acquiror's stock. In addition, depending on the allocation procedure employed, both short- and long-term investors may be able to receive their preferred consideration in the form of all cash or all stock. Those who choose not to cash out can retain the tax benefits of a tax-free exchange. In structuring a part-cash, part-stock pricing formula and allocating the cash and stock consideration pools, it is also important to consider how dissenting shares, employee stock options and other convertible securities will be treated.

A board of directors considering a proposal involving both cash and stock consideration should also seek the advice of counsel with regard to whether the transaction may invoke the enhanced scrutiny/*Revlon* duties. *See* Sections I.A.2 and I.B.1.

1. Possible Cash-Stock Combinations

There is a wide variety of potential pricing structures that can be utilized in a part-cash, part-stock transaction. Choosing the right pricing formula involves all of the complications raised in determining pricing formulas for an all-stock transaction (namely, the issues relating to fixed exchange ratios, floating exchange ratios, collars and walk-aways), plus the added complication of matching the formula for the stock component to the formula for the cash component. An important threshold issue is whether the values of the stock and cash components are meant to remain equal as the price of the acquiror's shares fluctuates or whether there will be scenarios in which the values of the cash and stock components can diverge. This will be an important consideration in determining the proper allocation procedures for the cash and stock components.

The simplest formula is a fixed exchange ratio for the stock component linked with a fixed per-share cash amount for the cash component, with fixed percentages of the seller's shares being converted into cash and stock, respectively. Because the value of the stock component of the transaction will vary with fluctuations in the acquiror's share price while the cash component remains fixed, it is important for the allocation procedures to be sensitive to the potential for significant oversubscriptions for stock, if the value of the acquiror's shares rises, and significant oversubscriptions for cash, if the value of the shares declines.

A more common hybrid pricing mechanism is to link a floating exchange ratio pricing formula for the stock component with a fixed cash price. This formula has the advantage of equalizing the stock and cash values (generally based upon the average trading price for the acquiror's shares over a 10- or 20-day trading period prior to the effective date of the merger). This approach helps facilitate a cash election procedure by

ensuring that there will not be an economic differential pushing stockholders towards either the cash or stock consideration. Issues may still arise in situations where the acquiror's shares trade outside the collar range established for the floating exchange ratio or where there is a last-minute run-up or decline in the price of the acquiror's stock.

There are limits to the flexibility that can be built into a part-cash, part-stock merger which is intended to qualify as a tax-free reorganization under Section 368 of the Internal Revenue Code of 1986, as amended. As noted in Section V.A.1., tax opinions are generally available in transactions in which up to 55% of the aggregate consideration is payable in cash. Post-agreement stock fluctuations may result in crossing that threshold. The parties should consider a mechanism for adjusting the stock-cash mix in the event that market conditions prevent the transaction from remaining a tax-free reorganization, such as a provision permitting the acquiror to adjust the stock portion if it is not otherwise possible to obtain the requisite tax opinion or a walk-away right at the bottom end of the range for which a tax opinion would likely be obtainable.

Adding an additional degree of complexity, most hybrid cash-stock mergers also have formula-based walk-away rights. The walk-away formula can be quite complex and is typically tailored to the specific concerns of the acquiror and target. Many part-cash, part-stock deals include some protection for target stockholders against a decline in the value of the acquiror's stock (to the extent the cash portion is not proportionally increased), in which case full walk-away protection is less important.

2. Allocation and Oversubscription

A key issue in part-cash, part-stock transactions is choosing the best method of allocating the cash and stock components to satisfy divergent shareholder interests. The simplest allocation method is straight proration without shareholder elections. In a straight proration, each of the seller's stockholders receives a proportionate share of the aggregate pools of stock and cash consideration. Thus, in a transaction in which 50% of the consideration is being paid in stock and 50% of the consideration is being paid in cash, each

stockholder exchanges 50% of his shares for acquiror stock and 50% of his shares for cash. Stockholders who exchange their shares for a mixture of cash and stock will recognize gain on the exchange to the extent of the lesser of (x) the gain on the exchange, measured as the difference between the fair market value of the stock and cash received over their tax basis in their shares, and (y) the amount of cash actually received. Such gain should be taxable as a capital gain as long as the target shares were held as a capital asset. The main drawback of straight proration is that target stockholders cannot choose their desired form of consideration and therefore all will likely recognize taxable gain.

A more common approach is the use of a cash election merger. Cash election procedures are designed to provide the seller's stockholders with the option of choosing between the cash and stock consideration. Such procedures allow the short-term investors to cash out of their positions while longer-term stockholders can exchange their shares in a tax-free exchange. Cash election procedures work best where the value of the cash and stock pools is equal and where there is a proportionate split between short- and long-term investors approximating the split between the available cash and stock consideration.

It has been the general experience to date that in most public company mergers involving medium- to large-sized target companies, target stockholders will be divided roughly equally between those desiring cash and those desiring stock. Institutional investors (many of which are tax-exempt institutions and thus indifferent between a taxable and tax-free exchange) tend to opt for the cash consideration, while individual shareholders (including target company insiders) tend to opt for stock. There can be no certainty at the outset, however, that this will be the case. Accordingly, the contractual provisions and related public disclosures concerning the election procedures must be drafted carefully to deal with the possibility that there may be significant oversubscriptions for one of the two pools.

Of course, the easiest way of assuring simplicity in a cash election process is to provide for straight proration in the event of oversubscriptions for either the cash or the stock pool. This allocation method is still preferable to a straight proration

without election procedures, because even if there are oversubscriptions, some stockholders will elect to receive the undersubscribed consideration and some stockholders will not return an election form and can be deemed to have elected to receive the undersubscribed consideration. Proration in this context, however, also, has certain significant drawbacks. Few shareholders will be fully satisfied because most will get a prorated portion of the undesired consideration and will also incur some taxation. The tax consequences of exchanging the seller's shares for a mixture of cash and stock consideration can be somewhat severe since, depending upon the shareholder's tax basis in the seller's shares, the shareholder can recognize gain up to the full extent of the cash received. Proration within the oversubscribed election pool will be most compelling when there is a significant difference between the value of the cash and stock consideration that is driving the oversubscriptions.

The more common approach for handling oversubscriptions has been to select shareholders on a random or other equitable basis from those who have elected to receive the oversubscribed consideration until a sufficient number of shares are removed from the oversubscribed pool. This procedure generally focuses on ensuring that most shareholders wishing to effect a tax-free exchange can do so, while minimizing the number of shareholders whose elections are not satisfied. The methods by which shareholders are selected for removal from the oversubscribed pool vary from a straight lottery to selection based on block size or time of election. Flexibility can also be preserved for giving preference to elections by officers and directors or other significant stockholders. Holders of director and employee stock options are also typically provided with an opportunity to roll over their stock options into options exercisable for acquiror shares at the exchange ratio. Since proration is less problematic in the event of an oversubscription for cash, there is some precedent for using proration for cash oversubscriptions, but a lottery selection process for stock oversubscriptions.

Companies engaging in cash election transactions should be prepared to deal with persistent questions from shareholders from the time of signing of the merger agreement through the closing of the transaction. The most persistent questions will come from arbitrageurs wishing to understand the full

intricacies of the election and allocation process and the pricing variations. Because of the discount that generally exists between the price of the seller's shares and the transaction value, so-called "risk arbitrageurs" seek to accurately value the respective securities, carefully measure the risks and rewards of a potential investment and to limit the risks of any positions they may hold through various hedging techniques. Consequently, risk arbitrageurs will be extremely interested in the selection and allocation process since it may directly affect their investment and hedging strategies.

VI

Mergers of Equals

There have been significant merger of equals (MOE) transactions in recent years in a number of consolidating industries, most notably in the banking and financial institutions industry. In a true MOE, neither party to the transaction receives a control premium and neither party relinquishes control. Instead, control is shared between the parties. The exchange ratio is set to reflect the relative asset, earnings and capital contributions and market capitalizations of the two merging parties – typically resulting in an exchange at near market-to-market levels (although a variety of other factors can be and are often taken into account in determining a fair basis on which to combine the two entities). MOEs can be difficult to negotiate and hard to execute. Because MOEs do not provide shareholders with a control premium, it is essential that any proposed transaction be structured as a true combination of equals. The appearance, and reality, of balance are both essential. Common goals and vision are key and cooperation must begin at the highest levels of each company, where difficult decisions frequently must be made.

The successful implementation of a merger of equals requires careful advance planning. It is critical that a positive stock market reaction to the transaction be obtained in order to reduce both parties' vulnerability to shareholder unrest and/or a competing offer following the announcement of the deal. While cross stock options can provide some economic and structural

protection against competing offers, the protection is often incomplete, especially for smaller transactions. Strong market support and a strong business rationale for the merger are needed to assure consummation of the deal.

MOE consolidation in an industry can lead to compelling best-of-the-breed combinations. The unprecedented series of three mega-mergers (NationsBank/BankAmerica, CitiCorp/Travelers and Banc One/First Chicago) in the financial institutions industry within one week in April of 1998, as well as recent substantial transactions in other industries, suggest that the compelling business dynamics that can be found in an MOE transaction can help brush aside competitive rivalries, which are typically a significant impediment in reaching an MOE agreement. These MOE transactions reflect a true partnership perspective, adapting the best aspects of both institutions in order to accomplish the combination. That perspective can aid in resolving pricing issues as well as "social" issues that typically pose difficulty in any MOE transaction, such as CEO and management positions, board seats, headquarters and corporate name.

A. The Advantages of an MOE Structure

MOEs can be an attractive avenue for growth. MOEs can help enhance shareholder value through merger synergies and are less costly than high premium acquisitions. In industries with a dwindling supply of accretive acquisition targets, MOEs often represent the only effective avenue available to would-be acquirors for a large scale expansion. MOEs are also an attractive alternative for smaller companies that would not otherwise have the interest, opportunity or financial capability to launch a large-scale expansion program.

An outright sale of a company is often an unattractive alternative for a variety of business, economic and social reasons. Management and boards like to maintain control and properly perceive their duty as managing their companies for the long-term benefits of their shareholders and other significant constituencies. While some sales can be highly beneficial for shareholders, they typically result in the loss of the company as an independent presence in its community — which can be especially significant for older, well-established companies.

Shareholders too can lose in an outright sale or merger with a larger acquiror, by being cashed out of their investment prematurely or being forced to accept an equity security in a company that is significantly different from the one in which they originally invested. Often, the best business fit for a company is combining with a comparably sized competitor that best complements its operating strengths and long-term business strategy.

In any stock-for-stock merger transaction, the value of the consideration received is highly dependent upon the acquiror's future performance. There is no better way to protect the shareholders' investment than to ensure a significant continuing management role for the company's existing directors and management team. MOEs allow the best people from both organizations to manage the combined company, thus enhancing long-term shareholder values. Many MOEs allow the parties to achieve significant cost savings and operational efficiencies, again borrowing the best from both parties. Assuming a proper exchange ratio is set, MOEs allow for a fair and efficient means for the shareholders of both companies to share in the merger synergies.

MOEs are not right for all companies, and the rationale for any MOE transaction must be carefully considered in advance. Parties to an MOE should expect their transaction to be closely scrutinized by the analyst, investor and acquiror communities, who will eagerly jump at the opportunity to exploit any weakness in the rationale put forward for the proposed deal.

B. Resolving the Key Governance Issues

To achieve a true MOE structure, ideally neither company should gain too much of an upper hand in the combined company. Instead, after agreeing on the overriding business goals and means to enhance shareholder value, partners to an MOE must seek to achieve a fair balance in key management and operational areas. Management compatibility is extremely important, and MOE agreements are almost always struck at the CEO-to-CEO level.

Among other key issues to be addressed in an MOE structure are:

- The split of the board (typically a 50/50 split, although in some situations a slight majority in favor of one party may be warranted (and if one or both parties have a significant shareholder with board representation, those directors will often be treated separately); agreements concerning committee structure and membership are also common);

- The split of the Chairman and CEO position (frequently one party gets the Chairman position and the other gets the CEO position, although sometimes the CEO of one party assumes both the Chairman and CEO title while the CEO of the other party is guaranteed the title after a specified transition period; co-CEO positions, while often unwieldy, are sometimes utilized; retirement age and use of consulting agreements are often taken into account);

- The selection of the combined senior management team (typically involves roughly an equal number of executives from both companies; the specific allocation of duties among key management team members is often addressed, sometimes in exacting detail; existing employment arrangements must also be considered; employment contracts often require modifications to protect employee and company interests and to reflect the newly proposed management structure);

- The rationalization of separate corporate cultures (including attitudes towards compensation, employee benefit and incentive plans, management styles, use of technology, operating priorities and future business strategies);

- Identification of merger synergies (a fair sharing of any "social costs" and operational disruptions associated with the proposed merger synergies is important, as is a unified approach to any severance arrangements);

- The company's name (many options exist – *e.g.*, a new name, a combined name, retention of one of the old names, retention of one name for some operations and the other name for other operations);

- Location of corporate headquarters and other key operations (often based on costs and operational considerations, but can be a key social issue in MOEs involving companies headquartered in different cities or states);

- Legal structure of the merger and choice of a surviving entity (the manner in which the merger is structured can affect the public perception as to whether one of the parties is "being acquired"; legal structure can also have important tax, regulatory and state law consequences; "newco" structures are frequently used to avoid having to choose between either of the merging parties);

- The exchange ratio (the nature of the premium, if any, and how the premium is expressed can have an important impact on the public perception of the transaction; the pro forma dividend payout ratio must also be considered).

In most transactions, there is a trade-off among these various key issues, as the parties strive to achieve the perception, and the reality, of a fair balance of power and to benefit from each party's strengths.

Negotiating a fair and equal balance of power is often difficult, and may actually run counter to the long-term objective of ensuring a successful integration of the two companies (which may require the existence of one dominant, visionary force within the combined company). The success or

failure of an MOE most often rests on the strength of the CEOs who bring the transaction together and their ability to work effectively to ensure a smooth transition to a new unified corporate culture. No easy formula for success exists. Each situation must be judged on the basis of individual facts and circumstances, with sensitivity to the personalities involved and their respective talents and weaknesses.

At the outset of any MOE, it is essential to recognize that the best legal protections in the world are inadequate substitutes for a deeply held commitment and trust, based on a potential partner's past performance, behavioral style, reputation and culture. Each organization is unique and differing management styles are common. It is impossible to envision all of the pitfalls and complexities that will arise, and compatibility of objectives, philosophies and personalities is required.

The discussion and resolution of governance issues should be handled carefully to avoid any actual or perceived conflict of interest. The personal interests of directors or officers must not be put before the interests of the company's shareholders, employees and other important constituencies. However, arrangements that ensure that shareholder, employee and community interests are properly protected are legitimate to consider. The resolution of these key governance issues is highly relevant to the value of the combined company and its future prospects, and no MOE can proceed unless both parties are comfortable with the resolution.

Once an agreement is reached concerning the key governance issues, it will be important that appropriate provisions are put in place to ensure that both parties live up to the bargain. Nothing is as certain as the fact that no matter how close the parties are before the transaction, things *will* change after the merger. While no set of legal rules can fully protect the parties against changes that occur after the merger, some basic protections should be built into the merger agreement, the key executives' employment agreements and, in some instances, even the new company's charter, by-laws and operational statements. Among other areas which deserve written protections are: principal executive officer successorship provisions, board successorship provisions (both pre- and post-

merger for a specified duration) and any super-majority voting provisions.

C. The MOE Merger Agreement

The merger agreement for an MOE should be a balanced contract with matching representations, warranties and interim covenants from both parties. MOEs are typically structured as tax-free, stock-for-stock transactions (poolings where that is relevant), with a fixed exchange ratio without collars or walk-aways, and, if applicable, the contract will need to address the standard provisions relating to stock-for-stock pooling transactions. MOE agreements generally include only limited closing conditions. It is also customary for the agreement to contain a strong no-shop provision and limited, if any, fiduciary out provisions.

While due diligence window provisions could in theory be incorporated into an MOE agreement to alleviate the need for full-scale due diligence prior to the announcement of the transaction, such provisions are generally disfavored for fear of providing the market with a message that the merger has been less than fully thought through or not fully committed to by both parties. Defining the appropriate scope of pre-signing due diligence is a critical issue, since premature disclosures or leaks can seriously jeopardize an MOE. Each situation must be assessed carefully to achieve the proper balance of pre- and post-signing due diligence and integration planning.

Any company considering a potential MOE transaction should be prepared for a deliberative and painstaking process. MOEs are rarely put together overnight and often involve months, and sometimes years, of preliminary exploratory conversations. Given the complex business considerations and personality issues presented in an MOE transaction, it is not surprising that many MOE discussions never result in a transaction. In light of this fact, companies should not place too great a weight on early exploratory meetings, and should be cautious to avoid external leaks and the build up of internal expectations.

Parties to an MOE should proceed with caution. As history has shown, a poorly planned MOE can be a recipe for

disaster. When all things fit, however, an MOE can be the most successful form of business combination. Some of the most successful bank holding companies today are the result of successful MOE transactions.

D. Fiduciary Issues and Fairness Opinions in MOEs

MOEs do not involve a "sale of control" of either company within the meaning of the applicable case law on directors' fiduciary duties. Accordingly, directors have broad discretion under the business judgment rule to pursue an MOE transaction that they deem to be in the best long-term interests of their company, its shareholders and its other important constituencies, even if they recognize that an alternative sale or merger transaction could deliver a higher premium over current market value.

Comparing MOEs to sales of control is like comparing apples and oranges, and an MOE can be fair even though the post-announcement trading value of the company's shares is less than that which could be achieved in a sale transaction. It is prudent, however, for the board, as part of its deliberative process, to consider what alternative business strategies might exist, including an affordability analysis of what potential acquirors could pay in an acquisition context. The Delaware courts, in the *Time* and *QVC* decisions and elsewhere, have indicated that directors have wide latitude in pursuing long-term strategic objectives through an MOE or similar strategy, as long as the strategy does not involve a sale of control. Notably, the original Paramount/Viacom merger was a rare example of a purported merger of equals that actually involved a change of control — since the post-merger entity would be controlled by one individual.

An MOE should be analyzed on its own merits with active board involvement. Detailed presentations should be made to the boards concerning the benefits of the transaction and the plans for integrating the two companies — ideally over a period of several meetings. A thorough analysis of the strengths and weaknesses of the merging parties, including a critical assessment of the due diligence results and the projections, forecasted synergies, and related restructuring changes, is also appropriate. There are numerous examples of

failed MOE transactions, and boards considering the benefits of a proposed MOE should carefully consider these lessons of the past. Frequently, a merger partner may be engaged in an entirely different line of business, and it is extremely important for the board to gain a comprehensive understanding of that business and the associated risks and opportunities.

A fairness opinion is important for both companies. Fairness opinions in MOE transactions must be carefully crafted to provide clarity as to what is and is not being covered in the opinion. While extensive explanations are not required, or in most instances useful, it is important to avoid the impression that the opinion is attempting to compare the proposed MOE to a sale of control. Careful attention to the proxy statement disclosure relating to the fairness opinion is also important.

In situations where competing offers have been received by one or both of the merging parties, extreme care should be taken in crafting the appropriate response and in drafting language for the fairness opinion and the related proxy statement disclosure. Emphasis should be placed on the board's independent business determination that pursuing an MOE as opposed to a sale of the company is the best long-term business strategy for the company.

A good example of the complexity that can arise in connection with fairness opinions rendered in MOE transactions occurred in connection with the 1990 merger of two insurance brokers, Corroon & Black and Willis Faber p.l.c. After the merger was announced, Aon Corporation made a cash proposal for Corroon & Black at a price above the current market value reflected in the MOE exchange ratio. Corroon & Black was able to reject the Aon proposal and proceed with its MOE transaction aided, in part, by the continuing validity of the fairness opinion it received from its investment banker. The opinion was amended after the Aon proposal to clarify that the banker was not addressing the relative merits of the MOE compared with alternative business strategies (such as pursuing a sale of the company), which was a matter that was within the board's business judgment, but rather that the banker was only addressing the fairness of the exchange ratio within the context of an MOE transaction.

E. Protecting the Deal

Many of the recent MOEs have attracted some degree of attention from potential interlopers questioning whether there was a way to step forward and acquire one, or in smaller MOEs even both, of the merger partners, and there are many examples of MOEs broken up by hostile interlopers.

While no protection is iron-clad, steps can be taken to protect an MOE transaction. First and foremost, it is important to recognize that the period of greatest vulnerability is the period before the deal is signed and announced. Leaks or premature disclosure of MOE negotiations can provide the perfect opening for a would-be acquiror to submit an acquisition proposal designed to derail the MOE talks or pressure one party into a sale or auction. Nothing will kill an MOE faster than a run-up in the stock of one of the merging parties – whether or not the run-up is based on takeover speculation – because no company wants to announce an MOE reflecting an exchange ratio that reflects a substantial discount to market.

A strong and unwavering commitment by both parties to the deal will help discourage interlopers. Any indication of internal dissension will encourage intervention. A careful strategy for explaining the rationale of the deal to the market is also important, as it can be considerably easier to bust up a deal that market analysts dislike than one that they applaud. A base of good shareholder and community relations can also be important.

Finally, structural protections such as cross stock options and support commitments are both necessary and appropriate. Cross stock options are appropriate, provided that the option terms are reasonable and do not deprive shareholders of a fair opportunity to vote on the proposed transaction. In bank transactions, notwithstanding that such provisions could prevent an interloper from using pooling of interests accounting, stock options on 19.9% of a target company's shares, including a put provision in lieu of exercise, have been standard over the past several years.

MOEs require the expenditure of enormous resources even to begin, much less see to fruition, a process that can take months to complete and involve substantial monetary and opportunity costs. Cross stock options, agreements by both parties not to shop their companies after the deal is announced, and an agreement not to terminate the merger agreement in the face of a competing offer without giving the shareholders a fair opportunity to vote on the merger, are all proper and appropriate provisions for an MOE.

Utilization of a rights plan can also be appropriate to protect the parties to an MOE from hostile intervention. Since an MOE does not involve a sale of the company, parties to an MOE should send a strong signal that they have no intention of engaging in a sale transaction even if their MOE transaction is voted down by shareholders. While as a practical matter it may be difficult for the parties to avoid a takeover if an aggressive acquiror steps forward, the best defense is always a strong public commitment to remaining independent.