"NOVEL ISSUES" OR A RETURN TO CORE PRINCIPLES? ANALYZING THE COMMON LINK BETWEEN THE DELAWARE CHANCERY COURT'S RECENT RULINGS IN OPTION BACKDATING AND TRANSACTIONAL CASES

MARK LEBOVITCH WITH LAURA GUNDERSHEIM*

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* Mr. Lebovitch is a partner and Ms. Gundersheim is an associate at the law firm of Bernstein Litowitz Berger & Grossmann LLP, in New York. Mr. Lebovitch received his J.D. from New York University School of Law before clerking for Vice Chancellor Stephen P. Lamb of the Court of Chancery of the State of Delaware. Ms. Gundersheim received her J.D. from Harvard Law School. The views expressed in this article are solely those of the authors and do not necessarily represent the views of Bernstein Litowitz Berger & Grossmann LLP or any of its clients.

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I. INTRODUCTION

During the period from late 2006 through mid-2007, the Court of Chancery of the State of Delaware (the "Chancery Court" or "Court") asserted its jurisdiction and authority over numerous cases in situations where, in the past, it may have deferred to other jurisdictions. The Court's decisions on motions to stay in *Ryan v. Gifford*[1] and *In re The Topps Co. S'holders Litig.*[2] most clearly mark, but are just examples of, this new trend. The Court justified its assertiveness, which arose in option backdating derivative suits and class actions challenging "going private" merger and acquisition ("M&A") transactions, by emphasizing that the issues presented were "novel" and particularly important to the development of Delaware's corporate law.

The factual nuances raised by the recent series of executive compensation and going private M&A cases may well be "novel." More importantly, we believe the Court's handling of these cases marked a deliberate effort to simplify the legal landscape surrounding the application of the business judgment rule, with potentially far-reaching and significant ramifications. We explore the reasons for this shift.

1. 918 A.2d 341 (Del. Ch. 2007).
2. 924 A.2d 951 (Del. Ch. 2007).

First, the Court is being pragmatic and protective of its central role in deciding shareholder claims for breach of fiduciary duty. In the nine months after the stock option backdating scandal emerged in March 2006, and throughout the first few years of the recent merger wave, shareholders filed many cases involving Delaware corporations in state or federal courts in jurisdictions outside of Delaware. High-profile efforts by federal regulators in the backdating and private equity fields also reignited discussion of the federalization of corporate law. It was thus necessary for the Chancery Court to clarify and affirm its authority so as to remain at the forefront of the evolving legal landscape.

Second, both option backdating and the recent going-private M&A wave raised issues of good faith conduct that cut to the very heart of Delaware's fiduciary duty law. If compensation is awarded in secret or through the manipulation of corporate records and processes (as is often the case with option backdating) or a corporate sales process is tilted to achieve the CEO's or other insiders' personal objectives at the expense of the Company's shareholders, the court is (and should be) assertive in its oversight. Such situations are substantively different from Michael Ovitz getting rich(er) after a weak board process, as was presented in the *In re The Walt Disney Derivative Litigation*,[3] or officers enjoying pre-existing golden parachutes as a "side effect" of an otherwise beneficial M&A deal. A rigid approach to applying the law to similar facts can lead to anomalous results, while a contextual approach focusing on the underlying facts and less on placing the claim in an artificial "bucket" should lead to consistent and more understandable outcomes.

Third, and perhaps most important, we believe that the Court, in bringing a contextual and appropriately skeptical approach to the latest legal developments, returned to its core and most important area of expertise – an institutional ability to sift through the nuances of complex business transactions in order to identify when improper motivations, *i.e.*, a lack of good faith, result in value-destructive conduct. Instead of being constrained by the "unfortunate proliferation of standards of review"[4] that can provide formulaic answers to these cases,

3. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).
4. Mercier v. Inter-Tel, Inc., 929 A.2d 786, 810 (Del. Ch. 2007).

the Court took a pragmatic approach, attuned to the real-world pressures and motivations that can and do affect corporate actions.

The business judgment rule has stayed essentially constant since its initial formulation. At its base, the rule says that unless the shareholder-plaintiff provides an adequate factual basis rebutting the presumption of good faith, director action in managing the affairs of a corporation should not be disturbed by second-guessing courts.[5] Yet the circumstances in which courts must apply the rule (or consider whether its strong presumption favoring director autonomy is rebutted) continually evolve. In the past few decades, the court's resolution of "new" or "novel" issues, particularly in the merger context, often led to the perception of one new "standard of review" after another.

When a formulaic application of the business judgment rule did not seem a clean fit to a board's response to a proxy fight, the Court's ruling gave rise to the so-called "*Schnell* standard."[6] Disparate treatment of groups of shareholders – but in a way that protected the corporation – gave rise to the "*Unocal* standard."[7] When a board created its own disabling conflict in weighing competing bids in the early 1980s, the Court's ruling became the "*Revlon* standard."[8] Director conduct that tended to disenfranchise shareholders gave rise to the "*Blasius* standard."[9] The *Revlon* standard's limits were defined by the "*Time/Warner* merger of equals" doctrine in 1989.[10] And the pragmatic "reasonableness" approach of *Unocal* seemed to give way to the more-rigid "preclusiveness" test of *Unitrin, Inc. v. American Gen. Corp.*[11] This pattern effectively continued every time a new set of facts did not fit readily into the then current business judgment rule framework.

5. *See, e.g.*, 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).

6. *See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971).

7. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

8. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

9. *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

10. *See* Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).

11. 651 A.2d 1361 (Del. 1995).

Starting at least in 1999, current and former members of the Court have voiced their desire to simplify these standards and bring the law back to a focus on the core underpinning to the business judgment rule – good faith.[12] As evidenced in the Court's most recent opinions, the egregious nature of some option backdating and the core loyalty questions raised in the recent going private merger context provided the Chancery Court with the right opportunity to issue thoughtful and meaningful opinions that focused on the underlying motivations and good faith of the defendant fiduciaries, while cutting back or simplifying the numerous "standards" that might otherwise compel inconsistent outcomes in seemingly similar corporate disputes.

The melding of "standards" in favor of an open-ended, but hopefully more manageable and pragmatic judicial approach to resolving fiduciary duty disputes, was best summed up in the Court's recent opinion in *Mercier v. Inter-Tel*:

> *Unocal,* when applied faithfully, requires directors to bear the burden to show their actions were reasonable. Implicitly. . . that requires directors to convince the court that their actions are motivated by a good faith concern for the stockholders' best interests, and not by a desire to entrench or enrich themselves. In other words, to satisfy the *Unocal* burden, directors must at minimum convince the court that they have not acted for an inequitable purpose. *Thus* Unocal *subsumes the question of loyalty that pervades all fiduciary duty cases, which is whether the directors have acted for proper reasons.* This aspect of the test thus addresses issues of good faith such as were at stake in *Schnell.*

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12. *See, e.g.*, *In re* Lukens Inc. S'holders Litig., 757 A.2d 720, 731 (Del. Ch. 1999) ("there are no special and distinct '*Revlon* duties'"), *aff'd sub nom.* Walker v. Lukens, Inc., 757 A.2d 1278 (Del. 2000) (unpublished table decision); Chesapeake Corp. v. Shore, 771 A.2d 293, 317-24 (Del. Ch. 2000) (discussing tension among various "standards" and noting that selection of standards may actually serve as a post-hoc justification for an outcome); *see also* William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law,* 56 BUS. LAW. 1287, 1298, 1311-16 (2001) (discussing the proliferation of standards and opining that "the truly functional standard of review is the test actually used by the judge to reach a decision, not the ritualistic verbal standard that in truth functions only as a conclusory statement of the case's outcome").

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> Consistent with the directional impulse of [*MM Co. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003)] I believe that the standard of review that ought to be employed in this case is a reasonableness standard consistent with the *Unocal* standard. I recognize in so stating that some of the prior *Unocal* case law gave reason to fear that that standard, and the related *Revlon* standard, were being denuded into simply another name for business judgment rule review. *More recent decisional law, one hopes, has been truer to the test as written, and our cases have universally recognized the need for close scrutiny of director action that could have the effect of influencing the outcome of corporate director elections or other stockholder votes having consequences for corporate control.*[13]

In sum, although the Court justified its assertion of authority on the "newness" of the issues, perhaps the more important point is that the Court may be shifting toward a simplified framework. It seems the Court is *de facto* viewing all cases based on the following principles, which highlight that the Court's influence is an outgrowth of its members' ability to assess corporate actions in a thoughtful, consistent, and sophisticated way: Board conduct, whether arising in the "stockholder ownership" or "corporate enterprise" context,[14] is always subject to the business judgment presumption, but the weight of evidence needed to forestall (if not rebut) application of the presumption is lower when addressing "ownership" decisions. If the evidence or allegations do not provide a basis to question the motivations of the individuals responsible for the challenged corporate conduct (defensive or otherwise), then those individuals are protected unless their actions otherwise constitute manipulation/bad faith or are beyond the scope of the board's grant of authority. If, on the other hand, the Court finds a credible (though not necessarily conclusive) basis to

13. Mercier v. Inter-Tel, Inc., 929 A.2d 786, 807, 809 (Del. Ch. 2007) (internal citations omitted).

14. *See* Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 147 n.47 (Del. 1997) (discussing the distinction between "ownership" vs. "enterprise" decisions by directors); *see also* Tooley v. Donaldson, Lufkin, & Jenrette, Inc., 845 A.2d 1031, 1033 (Del. 2004) (setting the standard for distinguishing derivative and direct claims).

question the motives of the fiduciaries, their leeway in structuring a process to favor one result (or bidder) over another will face thoughtful and nuanced scrutiny before the presumption of the business judgment rule attaches.

In Section II, below, we summarize the Court's recent assertion of its authority, in both rejecting motions to stay Delaware actions and similar procedural postures, in the option backdating and merger litigation contexts. In Section III, we assess the substantive issues posed by option backdating and conclude that although the methods at issue may be "novel," the practice, which was pervasive, cut to the very heart of fiduciary duty law. In Section IV, we review the recent takeover cases, and find a similar trend – the opinions turn on the underlying motivations of fiduciaries, and are not being decided with as much focus on the numerous standards of review that have evolved over the years.

II.
RYAN, *BRANDIN*, *TOPPS* AND THE COURT'S ASSERTION OF ITS OWN AUTHORITY

A. Ryan, Brandin *and the Chancery Court's Application of the* McWane *Doctrine to the Option Backdating Scandal*

Pursuant to *McWane Cast Iron Pipe Corp. v. McDowell-Wellman Eng'g Co.*,[15] a judge may stay or dismiss proceedings in a Delaware lawsuit in favor of a first-filed action pending in another jurisdiction where the first-filed suit is pending in a court capable of administering prompt and complete justice, and where both suits involve substantially similar parties and issues (the "*McWane* doctrine").[16]

In recent years, however, Delaware courts have found the application of the *McWane* doctrine to class and derivative actions "troublesome." This trend began in the late 1990's,[17] but did not pick-up steam until recently in the case of *Biondi v. Scrushy*.[18] In *Biondi*, Vice Chancellor Strine declined to apply

15. 263 A.2d 281 (Del. 1970).

16. *Id.* at 283-84.

17. Dura Pharms., Inc. v. Scandipharm, Inc., 713 A.2d 925, 929 n.1 (Del. Ch. 1998) (stating that *McWane* has less force in the representative context and citing prior cases to that effect).

18. 820 A.2d 1148 (Del. Ch. 2003), *aff'd sub nom. In re* HealthSouth Corp. S'holders Litig., 847 A.2d 1121 (Del. 2004) (unpublished table decision).

the *McWane* doctrine and denied defendants' motion to stay a later filed Delaware case in lieu of an earlier filed case pending in Alabama:

> [T]his court has proceeded cautiously when facing the question of whether to defer to a first-filed representative action and has given much less weight to first-filed status than is required in the non-representation action context. In particular, that caution has been motivated by a concern that the underlying client in interest in a representative action – the class or, in the case of a derivative action, the corporation – be represented effectively and faithfully. The mere fact that a lawyer filed first for a representative client is scant evidence of his adequacy and may, in fact, support the contrary inference. For those reasons, this court will not grant a stay simply because there is a prior-filed representative action in a court capable of doing prompt and complete justice. Instead, the court will examine more closely the relevant factors bearing on where the case should best proceed, using something akin to a *forum non conveniens* analysis.[19]

The court in *Biondi*, however, was careful not to diminish *in toto* the utility of the *McWane* doctrine, thus retaining the option of dismissing or staying cases when there was an earlier-filed action in a separate jurisdiction. Specifically, the Court held that the first-filed factor may be decisively important when:

> (1) a consideration of other relevant factors does not tilt heavily in either direction and there is a need for an objective tie-breaker to promote comity and assure litigative efficiency or (2) the court is assured by virtue of a judicial finding in the first-filed representative action (through a class certification ruling under Rule 23 or selection of lead counsel under the Private Securities Litigation Reform Act of 1995) or other record evidence that the plaintiffs in the action for which a stay was sought are adequately represented in the first-filed action.[20]

19. *Id.* at 1159 (footnote omitted).
20. *Id.* (footnote omitted).

During the past 12-18 months, Delaware courts have increasingly employed the *Biondi* framework to retain class and derivative actions in circumstances even when an earlier filed case was filed elsewhere. Nowhere is this practice more evident than in those cases pertaining to the backdating of stock options.

The first opportunity for the Chancery Court to grapple with allegations pertaining to the backdating of stock options arose in the case of *Ryan v. Gifford*.[21] Plaintiff Walter E. Ryan filed a derivative action in the Court of Chancery against certain of the officers and directors of Maxim Integrated Products, Inc. ("Maxim"), a company headquartered in California, alleging that Maxim's officers and directors breached their fiduciary duties by approving backdated stock options in violation of shareholder-approved stock option plans.[22] Defendants moved to dismiss and in the alternative to stay the Delaware action under the *McWane* doctrine in favor of two earlier filed cases – one pending in federal court in the Northern District of California and the other pending in California Superior Court.[23]

Noting that the application of the *McWane* doctrine "presents great difficulty in shareholder derivative actions,"[24] Chancellor Chandler examined both the adequacy of the competing complaints and each of the potential court's ability to render justice.[25] The Court focused on the second factor in denying defendants' stay request, holding that Delaware courts have a "'significant and substantial interest in overseeing the conduct of those owing fiduciary duties to shareholders of Delaware corporations.' This interest increases greatly in actions addressing novel issues."[26] According to the Court, determining whether the undisclosed practice of backdating option grants "violates one or more of Delaware's common law fiduciary duties. . .encompasses numerous issues, including the propriety of this type of executive compensation, requisite disclosures that must accompany such compensation, and the

21. 918 A.2d 341 (Del. Ch. 2007).
22. *Id.* at 346.
23. *Id.* at 348.
24. *Id.* at 349.
25. *Id.* at 349-50.
26. *Id.* (quotation omitted).

legal implications of intentional non-compliance with shareholder-approved plans."[27] Since no Delaware court had yet addressed these issues, the Court concluded it appropriate to remove any doubt regarding Delaware law by retaining jurisdiction over the case and elucidating the fiduciary principles applicable in the stock option backdating context.[28]

Several months after *Ryan* was decided, Vice Chancellor Lamb dealt with a similar issue in *Brandin v. Deason*.[29] Plaintiff Jan Brandin filed a derivative action in Delaware against certain of the officers and directors of Affiliated Computer Service, Inc. ("ACS"), a company headquartered in Texas. Like the plaintiff in *Ryan,* Brandin alleged that ACS's officers and directors breached their fiduciary duties by approving backdated stock options in violation of shareholder-approved stock option plans.[30] Other plaintiffs followed, bringing similar claims in a variety of different courts, including one in federal court in the Northern District of Texas.[31]

More than a year after the filing of Brandin's original complaint, and several months after 16 defendants answered the amended complaint, three defendants moved to stay the Delaware action in favor of the Texas action. These Defendants argued that the Delaware case was a subset of the Texas case, which alleged a number of federal securities claims not at issue in Delaware and that, because Brandin lacked standing to contest some of the stock options at issue, the Delaware case would not resolve state law claims that encompassed the majority of the alleged misconduct.[32] Defendants also asserted that allowing the case to proceed would result in duplicative and wasteful litigation, and that they would be "saddled with great hardship" by having to litigate in Delaware.[33] In response, Brandin argued that the Delaware case had progressed more rapidly than the Texas case, that the defendants' stated hardships were pretextual and that the Chancery Court had an overriding interest in hearing the case because "it involves a type of fiduciary malfeasance – stock options backdating –

27. *Id.* at 350.
28. *Id.*
29. 941 A.2d 1020 (Del. Ch. 2007).
30. *Id.* at 1022.
31. *Id.*
32. *Id.* at 1023.
33. *Id.*

which has the potential to raise unsettled, yet important, questions of Delaware corporate law."[34]

Like Chancellor Chandler in *Ryan*, Vice Chancellor Lamb observed that *McWane* had limited application in derivative cases, based on the *Biondi* framework outlined above.[35] Noting that "the law governing all of the intricacies potentially associated with stock options backdating claims is far from well-settled," that "Delaware courts have a sizable interest in resolving such novel issues to promote uniformity and clarity in the law that governs a great number of corporations," and that "stockholders of companies incorporated in this state would suffer a disservice if Delaware courts suddenly became a forum of last resort, available for only that small percentage of representative suits which do not, at least in theory, overlap with issues of the federal securities laws," Vice Chancellor Lamb denied the motion to stay.[36]

B. Topps *and the Chancery Court's Application of the* McWane *Doctrine to the "Going Private" Merger Wave*

The Chancery Court's assertion of its jurisdiction over derivative and shareholder class actions extended to the influx of cases challenging "going private" takeovers between 2006 and 2007. In particular, in *In re The Topps Co. S'holders Litig.*,[37] Vice Chancellor Strine explained that the recent wave of going-private transactions, involving private equity buyers who intend to retain a target's existing management, has given rise to important and novel issues under Delaware corporate law that are best determined by Delaware courts.[38] In *Topps*, two private equity firms announced that they had entered into a preliminary agreement to purchase The Topps Company Inc. ("Topps") by way of a merger.[39] Shortly thereafter, nine stockholders of Topps filed class action lawsuits challenging the proposed merger – four in the Supreme Court of the State of New York, where Topps is headquartered, and five in the Court of Chancery, where Topps is incorporated. The first

34. *Id.*
35. *Id.* (footnote omitted).
36. *Id.* at 1024, 1027.
37. 924 A.2d 951 (Del. Ch. 2007).
38. *Id.* at 954.
39. *Id.*

lawsuit was filed in New York, and the first Delaware-based action was filed the next day.[40] The Delaware proceedings moved along more swiftly than the New York proceedings, but plaintiffs in both New York and Delaware sought to preliminarily enjoin the proposed merger.[41]

Citing the "first-filed rule" and *McWane*, Topps argued that the Delaware Action should be dismissed or, in the alternative, stayed in favor of the New York action. Because the actions involved the same parties, issues and facts, and because the New York court previously indicated that it intended to proceed with the New York Action, Topps argued that litigating in both Delaware and New York simultaneously would result in unnecessary expense and would risk inconsistent rulings on the same issues.[42]

The Court rejected Topps' motion to dismiss or stay. Noting that "only two Delaware decisions have so far touched on the issues raised in the current deal environment," the Court stated that the *Topps* merger was:

> [P]art of a newly emerging wave of going private transactions involving private equity buyers who intend to retain current management. This wave raises new and subtle issues of director responsibility that have only begun to be considered by our state courts. This factor bears importantly on the question of where this case should be heard. When new issues arise, the state of incorporation has a particularly strong interest in addressing them, and providing guidance.[43]

Because of the novelty of the issues presented, Vice-Chancellor Strine, like Chancellor Chandler in *Ryan*, emphasized Delaware's need to interpret its own law:

> As with the phenomenon of stock options backdating, Delaware has an important policy interest in having its courts speak to these emerging issues in the first instance, creating a body of decisional authority that directors and stockholders may confidently rely upon. Indeed, in Delaware's system of corporate law,

40. *Id.* at 954-55.
41. *Id.* at 957.
42. *Id.* at 953.
43. *Id.* at 954 (footnote omitted).

> the adjudication of cases involving the fiduciary duties of directors in new business dynamics is one of the most important methods of regulating the internal affairs of corporations, as these cases articulate the equitable boundaries that cabin directors' exercise of their capacious statutory authority.[44]

Although the Court rejected the application of the *McWane* doctrine, it did leave open the option of granting a stay motion by defendants in a similar factual scenario in the future: "[t]his is not to say that the consideration of which action is first filed cannot play a useful tie-breaking role when all other considerations are equal."[45]

The *Topps* decision is notable for another reason. Vice Chancellor Strine seemed to go out of his way to prevail upon plaintiffs to not hesitate to file valid claims involving Delaware law in Delaware. Providing a long-string cite to recent Delaware cases finding for stockholder-plaintiffs, the Court sought to assure shareholders that they would get a fair hearing always, and if they presented valid claims, could expect to secure "important relief" in the Delaware courts.[46] This commentary must be placed in context. Until *Ryan* was issued in February 2007, a large number of option backdating suits involving Delaware corporations were filed in the state or federal courts of other jurisdictions. In addition, the Caremark merger litigation, which is discussed in greater detail below, presented the rare major merger lawsuit in Delaware that never involved a motion to consolidate multiple actions and to appoint lead counsel. Only one shareholder plaintiff, Louisiana Municipal Police Employees' Retirement System, initiated suit in Delaware, while numerous plaintiffs challenged the deal in Caremark's state of headquarters, Tennessee.[47]

The Court's limitation of the *McWane* doctrine in certain representative actions, as exemplified by its decisions in *Ryan*, *Brandin* and *Topps*, did not undermine the doctrine generally.

44. *Id.* at 960 (footnote omitted).

45. *Id.* at 957.

46. *Id.* at 962 n.39. Vice Chancellor Strine went on to assure stockholder-plaintiffs that their lawyers "will receive appropriate remuneration in this court for achieving an important benefit for the corporation or a class of shareholders." *Id.*

47. Louisiana Mun. Police Employees' Ret. Sys. v. Crawford, 918 A.2d 1172 (Del. Ch. 2007).

For example, in *Kaufman v. Kumar*,[48] Vice Chancellor Lamb looked to *McWane,* dismissing an action brought by a special litigation committee in favor of an earlier filed action in the Eastern District of New York, where the underlying issues were not particularly unsettled under applicable law. Nor has the *McWane*-lite approach to the representative action spilled over into circumstances in which multiple individual actions have been filed in multiple jurisdictions. For example, in *Citrin Holdings LLC. v. Cullen 130 LLC*,[49] the Court granted Defendant Cullen's *McWane* based motion to stay in favor of an earlier filed acted pending in Texas. In *Diedenhofen-Lennartz v. Diedenhofen*,[50] the Chancery Court granted defendants' *McWane* based motion to dismiss in favor of earlier-filed actions pending in the courts of Germany, Canada and California, where the underlying issues were linked to non-Delaware law.

Asserting the Court's authority to hear certain types of cases is one thing. What the Court does with that authority is another. As explained below, while assessing these new factual scenarios, the Court may also be moving towards a more pliable and more meaningful inquiry into whether the presumption of good faith business judgment should attach to particular cases.

III.
THE CHANCERY COURT'S RULINGS IN THE OPTION BACKDATING CASES AND A STRENGTHENED GOOD FAITH STANDARD

A. *Option Backdating Cannot Happen Without An Intentionally Manipulated Process*

It appears that the Chancery Court's asserting its jurisdiction in the stock option backdating cases was driven, in large measure, by the egregious self-dealing and severe corporate governance failures that lie at the heart of the typical option backdating scenario. The practice of stock option backdating often involves the fabrication of corporate records or a board exceeding its statutory or contractual (via the corporate charter) authority. The practice is particularly virulent in that it can generate massive, undisclosed and illegal profits for com-

48. C.A. No. 2418-VCL, 2007 WL 1765617 (Del. Ch. June 8, 2007).
49. C.A. No. 2791-VCN, 2008 WL 241615 (Del. Ch. Jan. 17, 2008).
50. 931 A.2d 439 (Del. Ch. 2007).

pany officers, executives and directors at the direct expense of the company and its shareholders.

Stock options are granted by public companies as part of compensation packages for executives – supposedly to create incentives for them to boost long-term corporate performance and profitability. "Backdating" is the practice of picking an option-grant date earlier than the actual date the option was granted – typically when the stock price was lower than the actual grant date. "Spring-loading" is the practice of granting the stock option just before the company issues positive news which will likely push the stock price up, the executive gets an instant and riskless profit.

At its core, therefore, stock option backdating and spring-loading involves fiduciaries manipulating a corporate process order to line their own pockets at the expense of the corporation and its shareholders. It is this abuse of power that differentiates the option backdating cases from other (seemingly similar) cases pertaining to executive compensation. For example, *In re The Walt Disney Co., Derivative Litigation*[51] – the paramount Delaware executive compensation case of recent years – Chancellor Chandler ruled in favor of The Walt Disney Company's board of directors in a shareholder derivative action challenging the hiring in 1995 and subsequent controversial termination in 1996 of Michael Ovitz as president of Disney.[52] Disney's stockholders claimed that the members of Disney's board at the time those decisions were made did not properly evaluate Ovitz's employment contract and the subsequent no-fault termination, which resulted in a severance package to Ovitz valued at approximately $140 million after only 14 months of employment.[53] Despite finding that Disney's CEO, Michael Eisner was a "Machiavellian imperial" and CEO who had "enthroned himself as the omnipotent and infallible monarch of his own personal Magic Kingdom" and that Disney's Board of Directors was both "supine" and "passive," the Court held that Disney's directors did not breach their fiduciary duties or waste Disney's assets.[54]

51. 907 A.2d 693 (Del. Ch. 2005).
52. *Id.* at 697.
53. *Id.*
54. *Id.* at 760, 761, 763.

The Disney Court's holding was largely dependant on its finding that no director – other than Ovitz – had any financial interest in Ovitz's hiring, the terms of his employment or his firing.[55] With respect to Ovitz, the Court found that he owed no duty of loyalty prior to his employment and therefore did not breach any such duty in negotiating or accepting his employment agreement, and that he played no role in determining the basis for his termination or in Disney's decision to make the payment required for a termination without cause.[56] Accordingly, the Court held that Ovitz's receipt of the severance payment did not breach his duty of loyalty and that the board, although no paragon of good corporate governance, had not acted in bad faith.[57]

B. *The Chancery Court Decided Option Backdating Suits Amid Increased Sensitivity to Executive Compensation Abuses*

Throughout much of 2006 and early 2007, the option backdating scandal was front page news and subjected hundreds of companies to scrutiny from the United States Securities and Exchange Commission and Department of Justice. Although prior to 2007, Delaware courts had dealt extensively with issues of executive compensation, they had not grappled with cases specifically dealing with the backdating of stock options.

Until the Court issued its hugely influential opinion in *Ryan v. Gifford*, it was possible that option backdating suits could be dismissed as run-of-the-mill "*Disney*-style" compensation claims. As long as the recipients of the backdated options were not board members or constituted a minority of the board, one could conceive of rulings exempting from liability the board members who approved—directly or indirectly—backdated or spring-loaded stock options. Put another way, a strict application of the demand futility tests of *Aronson v. Lewis*[58] and *Rales v. Blasband*,[59] within the decisional framework of the *Disney* case, may have led to dismissals of derivative suits challenging option backdating or spring-loading.

55. *Id.* at 745, 757-58.
56. *Id.* at 757-58.
57. *Id.*
58. 473 A.2d 805, 814 (Del. 1984).
59. 634 A.2d 927, 934 (Del. 1993).

In fact, a number of the defendants in the stock option backdating cases argued that courts should rely on Chancellor Chandler's opening remarks in *Disney*, and find that requiring explicit disclosure of backdated or spring-loaded option grants would unfairly apply "'21st century notions of best practices'" to decades-old conduct.[60] As discussed below, the Court has rejected this argument rather forcefully, finding that option backdating and spring-loading cuts to the heart of Delaware's fiduciary duty law. Without expressly altering the traditional "demand futility" tests, the Court appears to have applied an unconstrained and realistic analysis of the issue that lies at the heart of whatever "standards" are applied – whether there is reason to question the board's good faith.

Before assessing the details of the Court's handling of this pervasive and nefarious practice, two developments predating *Ryan* are worth considering. As noted above, many plaintiffs chose to file their stock option backdating cases in jurisdictions outside of Delaware. In addition, federal regulators and members of Congress openly decried and opened investigations into the practice of option backdating.

Although the Chancery Court could do nothing but wait for the chance to speak publicly on the issue – and re-assert its leadership in matters of corporate governance – these two developments may have created additional pressures. As a recent article in *The News Journal*,[61] a local Delaware publication, highlighted, Delaware jurists and state officials are concerned with ensuring that Delaware maintain its stronghold as the "legal home for Corporate America."

Perhaps the single greatest threat to this bastion would be some form of a federal corporation law governing the internal working of publicly traded companies.[62] Even today, steps toward such a law receive support in Washington. In fact, The Shareholder Vote on Executive Compensation Act, which is

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60. *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693, 697 (Del. Ch. 2005).

61. Maureen Milford, *Delaware's Corporate Dominance Threatened,* NEWS J. (Del.), Mar. 2, 2008.

62. According to Delaware Supreme Court Chief Justice Myron T. Steele, federal encroachment on Delaware corporate law is a real threat, as it could cause the legal bar to "disintegrate: leaving 25 percent of the [Delaware's] lawyers unemployed." *Id.*

currently pending in the Senate[63] would require that public companies submit executive pay plans to a nonbinding shareholder vote each year. The Shareholder Vote on Executive Compensation Act is just the latest a series of proposed federal legislation receiving political support as a result of the stock option backdating scandal. During Senate hearings on the backdating scandal, Senator Chuck Grassley stated:

> *It is behavior that, to put it bluntly, is disgusting and repulsive.* It is behavior that ignores the concept of an "honest day's work for an honest day's pay" and replaces it with a phrase that we hear all too often today, 'I'm going to get mine.'" Even worse in this situation, most of the perpetrators had already gotten "theirs" in the form of six-and seven-figure compensation packages of which most working Americans can only dream. But apparently that was not enough for some. Instead, shareholders and rank-and-file employees were ripped off by senior executives who rigged stock option programs - through a process called "back-dating" - to further enrich themselves. *And as we have found far too often in corporate scandals of recent years, boards of directors were either asleep at the switch, or in some cases, willing accomplices themselves.*[64]

C. *The Court's Rulings Rest on a Pragmatic Good Faith Standard*

Although shareholders initially chose different venues for filing their suits, and politicians and regulators in Washington got a head start in pouncing upon the issue, the Chancery Court's rulings on the option backdating scandal have confirmed Delaware's preeminence in matters of corporate governance. In *Ryan*, Chancellor Chandler held:

> A director who approves the backdating of options faces *at the very least a substantial likelihood of liability, if only because it is difficult to conceive of a context in which a*

63. *Shareholder Vote on Executive Compensation Act: Hearing on S. 1181*, 110th Cong. (2007). A companion bill introduced by Congressman Barney Frank passed the House by a wide margin in April 2007.

64. Senator Chuck Grassley, Chairman, S. Comm. on Finance, Prepared Opening Statement for Hearing on Executive Compensation: Backdating to the Future (Sept. 6, 2006), http://finance.senate.gov/hearings/statements/090606cg.pdf.

> *director may simultaneously lie to his shareholders (regarding his violations of a shareholder-approved plan, no less) and yet satisfy his duty of loyalty.* Backdating options qualifies as one of those rare cases [in which] a transaction may be so egregious on its face that a board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.
>
> *I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures,* obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, *is anything but an act of bad faith. It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary.* Well-pleaded allegations of such conduct are sufficient, in my opinion, to rebut the business judgment rule and to survive a motion to dismiss.[65]

Chancellor Chandler reached a similar conclusion with respect to option spring-loading in *In re Tyson* Foods, *Inc. Consol. S'holder Litig.*:

> Despite Defendants' efforts to downplay the severity of their conduct, there is little doubt that [a]t their heart, *all backdated options involve a fundamental, incontrovertible lie: directors who approve [such] an option dissemble as to the date on which the grant was actually made.*[66]

Vice Chancellor Lamb picked up the baton in *Conrad v. Blank*, holding that "[p]articularly in relation to option grants to senior officers or executives pursuant to plans that require at-the-money pricing, a finding of a pattern or practice of assigning improper measurement dates to option grants resulting in the issuance of millions of stock options with strike

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65. Ryan v. Gifford, 918 A.2d 341, 355-58 (Del. Ch. 2007) (footnote omitted). *See also In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563, 593 (Del. Ch. 2007) (finding that directors faced a substantial likelihood of liability for manipulated stock option grants because "[a] director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary").

66. *Tyson Foods*, 919 A.2d at 592.

prices set at a lower price than that required by the plan raises substantial risks of personal liability on the part of both the grant executives who got the options and the directors who approved them."[67]

In addition to raising doubt about the *good faith* of the grantors, as well as the grantees,[68] the Court has viewed backdating as a material disclosure issue. Most recently, the Court in *Weiss v. Swanson* concluded, "the obligation to disclose the policy of timing option grants alleged in [the stock option backdating complaints] arises simply from a 'moral intuition. . . that directors should be candid with shareholders' and this court's well-established definition of materiality. Such a determination is within the proper domain of fiduciary duty law, and requires reference only to well-established standards of fiduciary duty."[69]

The Chancery Court's renewed focus on executive compensation abuse has extended beyond the stock option backdating context. For example, in *In re InfoUSA, Inc. S'holders Litig.*, Chancellor Chandler dismissed most of a derivative complaint, laying out in detail for the benefit of shareholders' counsel the importance of pleading a derivative complaint with a specific explanation why each underlying claim constitutes a breach of duty by each director defendant.[70]

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67. 940 A.2d 28, 38 (Del. Ch. 2007).

68. *See, e.g.*, *Ryan*, 918 A.2d at 355 n.35 ("[I]t is difficult to understand how a plaintiff can allege that directors backdated options without simultaneously alleging that such directors knew that the options were being backdated. After all, any grant of options had to have been approved by the committee, and that committee can be reasonably expected to know the date of the options as well as the date on which they actually approve a grant. *Nor is it any defense to say that directors might not have had knowledge that backdating violated their duty of loyalty. Directors of Delaware corporations should not be surprised to find that lying to shareholders is inconsistent with loyalty, which necessarily requires good faith.*") (emphasis added).

69. C.A. No. 2828-VCL, 2008 WL 623324, at *8 (Del. Ch. Mar. 7, 2008) (footnote omitted); *see also id.* at *4 ("'[S]hareholders have a right to the full, unvarnished truth' in the area of executive compensation, and therefore directors as fiduciaries, have a duty to disclose all material information when seeking stockholder approval of an option plan, or when disclosing an option grant.") (quoting Tyson Foods, Inc. Consol. S'holder Litig., No. Civ. A. 1106-CC, 2007 WL 2351071, at *4 (Del. Ch. Aug. 15, 2007) (denying defendants' motion for judgment on the pleadings)).

70. No. Civ. A. 1956-CC, 2007 WL 2419611, at *25-26 (Del. Ch. Aug. 20, 2007).

Nevertheless, the Court upheld claims relating to compensation, stating that the business judgment rule:

> does not require the court to bless the conclusion of a director that is self-evidently nonsense on stilts, nor does it protect a board that looks into the sun and names it the moon. . . . *Where, as here, the directors sought shareholder approval of an amendment to a stock option plan that could potentially enrich themselves and their patron, their concern for complete and honest disclosure should make Caesar appear positively casual about his wife's infidelity.*[71]

Thus, the application of the business judgment rule is as protective of directors as ever, but the Court appears to be approaching these cases with a healthy dose of skepticism before the presumption attaches.

IV.
THE COURT'S RECENT M&A CASES REFLECT AN INCREASED FOCUS ON REAL-WORLD PRESSURES AND MOTIVES

As noted above, the *Topps* motion to stay opinion highlights the novel issues raised by the recent merger wave and Delaware's strong interest in regulating the development of law applicable to its own corporations – the so-called "internal affairs doctrine." This explanation is only partially satisfying. Private equity transactions involving management is hardly a new development. Although some of the nuance differs, these transactions are descendants of the management buyout transactions of the 1980s.[72] The real significance of the recent wave of cases may not lie as much in the difficulty or novelty of the underlying facts as it does in the Court's inclination to push Delaware law – ever so subtly but in a meaningful way – into a new direction, so as to appropriately ensure that the challenged mergers do not benefit officers or directors at the expense of the company's shareholders.

71. *Id.* at *25.

72. *See, e.g.*, Barkan v. Amsted Indus., Inc., 567 A.2d 1279 (Del. 1989); Roberts v. General Instrument Corp., No. Civ. A. 11639, 1990 WL 118356 (Del. Ch. Aug. 13, 1990); *In re* RJR Nabisco, Inc. S'holders Litig., No. Civ. A. 10389, 1989 WL 7036 (Del. Ch. Jan. 31, 1989).

A. *The Proliferation of "Standards of Review" in the Mergers and Acquisitions Context*

The law of fiduciary duties has arguably come full circle over a two decade span, shifting from a focus on the motive behind board conduct, to the effect of that conduct (without much distinction based on the underlying intent), and now back to the underlying motive.

1. *The "Motivation" and "Intent" Focus of the Cases of the 1980s*

The principal M&A cases and standards that developed in the 1980s generally recognize that a board facing a hostile takeover bid or considering a sale transaction may be motivated by interests other than those of the shareholders when the board is responding to unsolicited offers and taking defensive measures. Although these observations were made within the traditional framework of the business judgment rule, numerous "tests" and "standards" modifying the application of the rule emerged.

In *Unocal*, the court held that director conduct in the takeover context "should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment."[73] The Supreme Court added a common-sense "caveat," calling for "judicial examination at the threshold before the protections of the business judgment rule may be conferred," which is warranted by the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of corporation and its stockholders."[74] Nevertheless, the Supreme Court upheld the Unocal board's disparate treatment of shareholders because the record provided a benign and good faith justification for their tactics.[75] The case could easily have been viewed as a simple outgrowth of the business judgment rule. Instead, the *Unocal* standard of review was borne and is now a fixture of the mergers and acquisitions landscape.[76]

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73. Unocal Corp. v. Mesa Petroleum, Co., 493 A.2d 946, 954 (Del. 1985).
74. *Id.*
75. *Id.* at 956-57.
76. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287-88 (Del. 1988). *See, e.g*, *In re* The MONY Group, Inc. S'holder Litig., 853 A.2d 661 (Del. Ch. 2004); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003); *In re* Santa Fe Pac. S'holder Litig., 669 A.2d 59 (Del. 1995);

The *Revlon* case followed on *Unocal*'s heels, articulating the "duty to maximize" in the context of the sale of the corporation. At its heart, *Revlon* was a true loyalty case: the directors had a disabling conflict of interest because they were exposed to serious personal liability from debt holders.[77] *Revlon* did not create any new "duty" *per se*.[78] Rather, *Revlon* was the Delaware Supreme Court's recognition that, in the context of a corporate sale transaction, a fiduciary acting in good faith should quite naturally take all reasonable steps to maximize the price being paid to the shareholders.[79] The "rule in *Revlon* is derived from fundamental principles of corporate law and. . . its announcement did not produce a seismic shift in the law governing changes of corporate central."[80] Although *Revlon* was informative of how a board should act in a particular factual circumstance – the sale of corporate control – lawyers (and judges) nevertheless often speak in terms of "*Revlon* duties."

Subsequently, in 1989, the Court held in *Paramount Commc'ns, Inc. v. Time, Inc.* ("*Time/Warner*")[81] that a board just trying to implement a long-term strategy via merger is not likely to face any disabling motivation, and therefore will enjoy a greater level of judicial deference. The opinion led to a marked distinction in the depth of judicial review based on the structure (and result) of the transaction. A fair reading of the *Time/Warner* opinion, however, illustrates that both the Chancery and Supreme Courts reviewed the evidence reflecting the Time board's motivations with a fine tooth comb *before* determining to protect the board's choice of merger partner under

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Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987); Orman v. Cullman, No. Civ. A. 1039, 2004 WL 2348395 (Del. Ch. Oct. 20, 2004); Chesapeake Corp. v. Shore, 771 A.2d 293 (Del. Ch. 2000); *In re* Gaylord Container Corp. S'holders Litig., 753 A.2d 462 (Del. Ch. 2000).

77. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 178-80 (Del. 1986).

78. *See Mills*, 559 A.2d at 1288 ("there are no special and distinct "*Revlon* duties").

79. *In re* Lukens Inc. S'holders Litig., 757 A.2d 720, 731 (Del. Ch. 1999) ("*Revlon* duties" refer only to a director's performance of his or her duties of care, good faith and loyalty in the unique factual circumstance of a sale of control over the corporate enterprise.").

80. Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 n.2 (Del. 1989).

81. 571 A.2d 1140, 1150-51 (Del. 1989).

the business judgment rule.[82] In other words, once the presumption of the business judgment rule is found to apply, the Court's inquiry is all but over, but the Court must still (and in this case did) carefully assess the evidence relating to good faith in deciding whether the presumption applied under the facts presented. Indeed, the opinion cites a strong and convincing record that the board had a long-term business strategy to merge with Warner, and there is no sign in the opinion that the board wanted to do a deal with Warner for any self-interested reason or other improper motive.[83] Although the opinion helped to establish a limit to the scope of "*Revlon* duties," the opinion is really a straightforward application of the business judgment presumption in the M&A context.[84] Yet, again, however, it seemed a new "bucket" for classifying categories of cases emerged.

2. *The "Structure" and "Effects" Focus in the Cases of the 1990s and Early 2000s*

The most prominent cases of the 1990s, beginning with the 1994 opinion in *Paramount Commc'ns Inc. v. QVC Network Inc.,*[85] seemingly marked a shift in which the courts focused more attention on the structure of the transaction and the effect of board-approved deal protections in order to identify the appropriate standard of review, without as much regard for the intent behind the board's tactics. The focus on structure perpetuated the *Revlon* versus *Time/Warner* divide, and the Court focused on the scope and limits of board power in more absolute terms, as opposed to the propriety of its exercise in particular situations.

The court's analysis in the *QVC* opinion focused on the "change of control" nature of the board's favored deal with Viacom and the various ways the board locked-up its favored-deal, but did not focus on the motivations of the board.[86] The

82. *See generally* Paramount Commc'ns, Inc. v. Time, Inc., C.A. Nos. 10866, 10670, 10935, 1989 WL 79880, *3-*10 (Del. Ch. 1989) *aff'd*, 571 A.2d 1140 (Del. 1989); *Paramount*, 571 A.2d at 1143-49.

83. *Paramount,* 571 A.2d at 1143-49.

84. Query whether the outcome would be the same had Paramount made its hostile bid *before* Time and Warner decided to merge, and a deal with Warner was itself a defensive response to the Paramount bid.

85. 637 A.2d 34 (Del. 1994).

86. *Id.* at 38-41.

Delaware Supreme Court, in particular, ruled in absolutes, saying that a third party contract entered in violation of fiduciary duties is void *ab initio*.[87] This observation, though undoubtedly true, seems to sidestep the more difficult question of whether a particular deal protection or third-party contract will be acceptable in some circumstances (*i.e.*, when adopted by a board genuinely motivated by maximizing shareholder value) but constitute a breach of duty in another circumstance (*i.e.*, when adopted to serve some objective other than improving shareholder and corporate welfare).

The following year, the Delaware Supreme Court issued its opinion in *Unitrin, Inc. v. American General Corp.*,[88] which transformed the traditional reasonableness/balancing test of *Unocal* into a more structured framework that turned on the effects of challenged board conduct with less, and perhaps no, emphasis on the board's underlying motivations. The Chancery Court enjoined a board-approved stock repurchase program that would have increased the board's ownership of the company's stock from 23% to 28%, helping to prevent proxy contests.[89] Spending little time addressing the motives for the board's actions beyond their stated desire to protect shareholders from mistakenly or erroneously tendering their shares, *i.e.*, "substantive coercion," the Delaware Supreme Court reversed the injunction and held that, in applying *Unocal*, the Chancery Court should engage in a two-step process: the first question is whether the defensive measure is "coercive or preclusive" and, the second question is whether the defensive measure falls within a "range of reasonableness."[90] The Supreme Court did not preview or explain when a defensive measure might pass the first part of the test but fail the second.[91]

87. *Id.* at 51 ("The No-Shop Provision could not validly define or limit the fiduciary duties of the Paramount directors. To the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.").

88. 651 A.2d 1361 (Del. 1995).

89. *In re* Unitrin, Inc. S'holders Litig., Civ. A. Nos. 13656, 13699, 1994 WL 698483 (Del. Ch. 1994), *rev'd and remanded*, 651 A.2d 1361 (Del. 1995).

90. *Unitrin*, 651 A.2d at 1387-88.

91. Notably, in Chesapeake v. Shore, 771 A.2d 293, 320-21, 325, 333-34, 344-45 (Del. Ch. 2000), the Chancery Court parsed and in various ways criticized the *Unitrin* standard, and ultimately invalidated a defensive

Skip ahead to the latter part of the decade, and we see the focus on the effects of deal protections rather than the intent of those approving them continued with *Brazen v. Bell Atlantic Corp.*, where the Supreme Court upheld a $550 million termination fee as falling within the range of fees previously upheld as reasonable.[92] The Supreme Court focused its comparison of the fee in that case to fees in other cases, rather than comparing and possibly differentiating the underlying reasons why the boards approving those fees may have seen fit (or had improper reasons) to do so. The practice of "dead-hand poison pills" came to a crashing halt following the opinions in *Carmody v. Toll Brothers, Inc.*[93] and *Quickturn Design Systems, Inc. v. Shapiro,*[94] which questioned and then invalidated these types of board actions on the basis that they exceeded the absolute limits of board power. The boards' motivations were largely irrelevant.[95]

The pure "no-talk provisions," *i.e.*, prohibitions on boards speaking with a deal-topping bidder that did not include a "fiduciary out," that were at issue in *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.,*[96] and *Ace Ltd. v. Capital Re Corp.*[97] faced a similar fate. These cases could have been viewed as simple business judgment rule cases under *Time/Warner*, yet the court suggested the tactics used by those boards could not be reasonable because they set up a structure that eliminated board power impermissibly.

In *Omnicare, Inc. v. NCS Healthcare, Inc.*,[98] the Supreme Court's focus on which standard of review applies took total precedence over any underlying good faith analysis. The Chancery Court ultimately viewed the "lockup" provisions at

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supermajority voting provision while making clear that, irrespective of whether the provision was "preclusive" or "coercive," its adoption by a self-interested and ill-informed board did not fall within the range of reasonableness.

92. 695 A.2d 43 (Del. 1997).

93. 723 A.2d 1180 (Del. Ch. 1998).

94. 721 A.2d 1281 (Del. 1998).

95. When a board takes action outside the scope of its authority, it very likely is acting without good faith. Of course, an "innocent" action beyond the board's power will not typically lead to personal liability, in light of the protections of DEL. CODE ANN. tit. 8, §102(b)(7) (2001).

96. Nos. Civ. A. 17398, 17383, 17427, 1999 WL 1054255 (Del. Ch. 1999).

97. 747 A.2d 95 (Del. Ch. 1999).

98. 818 A.2d 914 (Del. 2003).

issue pursuant to the business judgment rule.[99] But the Court effectively applied a reasonableness test and found the defendants to have acted reasonably – in part because there was no real showing of an improper motive for the board to have locked up that deal completely – in a good faith effort to salvage the corporation's dwindling value.[100] A 3-2 split opinion of the Supreme Court took the opposite approach – holding that because *Unocal* applied to the deal protections, the preclusive nature of these lockups made them invalid, irrespective of the board's underlying intent.[101]

In sum, even if the results were typically correct, it appears that the selection and rigid application of "standards of review" appeared to take precedence over the real underlying issue – the presence or absence of good faith among the defendant board.

B. *The Going Private Boom of 2004-2007 and the Chancery Court's Return to Basics*

In *Chesapeake v. Shore*,[102] Vice Chancellor Strine took on, in one form or another, the proliferation of "standards" under Delaware law and urged that they be distilled to their core underlying principles. A few years later, Vice Chancellor Strine again, writing with former Chancellor Allen and now-Delaware Supreme Court Justice Jacobs, argued expressly that the various "standards" should be combined in a more functional way.[103] Through its various M&A decisions during the year 2007 (including "going private" deals that triggered "*Revlon* review" and in the *Time/Warner* "merger of equals" context), the Chancery Court appears to have shifted its focus away from fixed standards and back to an assessment of underlying intent and good faith.

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99. Omnicare, Inc. v. NCS Healthcare, Inc., 809 A.2d 1163 (Del. Ch. 2002).

100. *Id.*

101. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 930-33 (Del. 2003).

102. 771 A.2d 293 (Del. Ch. 2000).

103. *See generally* Allen et al., *supra* note 12.

1. *The* Caremark *Merger Litigation*

The Court's renewed focus on underlying intent emerged in *Louisiana Municipal Police Employees' Retirement System v. Crawford*, (hereinafter "*Caremark*,") in which the boards of Caremark Rx, Inc. and CVS Corp. initially negotiated a no-premium "merger of equals." Besides the use of a wide plethora of deal protections, the deal offered a series of benefits to Caremark senior officers and directors not provided to Caremark's other shareholders.[104] Caremark competitor Express Scripts, Inc. launched a hostile takeover bid and a public pension fund sued to challenge the Caremark board's embrace of CVS and almost instant rejection of Express Scripts' bid.

The standard to be applied created tension – a traditional "*Time/Warner*" style application of the business judgment rule may have left little room to assess the board's decision-making, while a more critical judicial assessment of the board's performance, *a la Revlon*, would mark a sharp departure from precedent. The Court identified the tension between the judicial deference typically accorded to "merger of equals" transactions, as required by *Time/Warner*, with the facts in the record that legitimately called into question the board's and senior management's true motivations:

> Whatever the merger's strategic significance, many Caremark directors and managers stand to benefit handsomely from this agreement, whether or not they remain employed by the combined entity. The merger constitutes a "change of control" for purposes of most of Caremark's senior executive employment contracts and many, if not most, such employees will find that their outstanding Caremark options become immediately exercisable at the time of the merger.[105]

The Court commented on the dissonance between Delaware law and the economic realities of the deal in the accompanying footnote:

> Even defendants such as Crawford, who will retain substantial authority as Chairman, benefit from this

104. 918 A.2d 1172, 1179 (Del. Ch. 2007).
105. *Id.*

> "change of control" acceleration of their options. Defendants insist that this "merger of equals" does not, however, constitute a corporate change of control for purposes of this Court's jurisprudence under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173 (Del. 1986). This brings to mind Lewis Carroll's Humpty Dumpty, who made a similar assertion when he claimed that "[w]hen I use a word. . . it means just what I choose it to mean – neither more nor less."[106]

Perhaps suggesting the Court's desire to assess director conduct based on a functional and pragmatic test rather than through the formulaic approach pushed by defendants, the Court added, "It is an unfortunate and disappointing spectacle, however, to watch a board of directors insist that it simultaneously deserves the protection of the business judgment rule because the company is not changing hands, while a massive personal windfall is bestowed because it is."[107]

Besides arguing that the *Time/Warner* application of the business judgment rule should immunize the board from judicial review, the defendants also justified what the Court described as the "full complement of deal-protection devices" that the Caremark board used to protect the merger by reference to what was considered "standard" or typical in similar transactions.[108] Marking a subtle departure from the approach taken in *Brazen* and other opinions that approved termination fees based on prior practice, the Chancellor responded, "this argument by custom fails to convince."[109] Although Chancellor Chandler did not enjoin the deal on the basis of the deal protections, he made clear that a wide range of circumstances (rather than a fixed and defined test) would factor into the review of such provisions, and that the propriety of such defensive measures would be assessed on a case-by-case approach.[110] This aspect of the *Caremark* ruling builds off of the Court's 2004 ruling in *In re Toys "R" Us, Inc. S'holder Litig.*, in which Vice Chancellor Strine upheld a wide range of

106. *Id.* at 1179 n.6.
107. *Id.* at 1180.
108. *Id.* at 1184.
109. *Id.* at 1181 n.10.
110. *Id.*

deal protection devices as not being preclusive, while making clear that such provision would not be reviewed on a "one size fits all" basis.[111] Thus, even when the Court concerns itself primarily with the *effects* of a deal protection, it is possible that the motive underlying board support for a particular deal may well help to tip the balance of reasonableness in one direction or another.

Finally, even the Court's interpretation of Delaware's appraisal statute appears to have been affected by the Court's sense of the board's underlying motivations. CVS "allowed" Caremark's board to issue a dividend to the company's shareholders, conditioned on the shareholders' support for the CVS deal.[112] The shareholder plaintiffs argued that the inclusion of cash in the deal consideration triggered appraisal rights, while defendants asserted that the dividend did not serve as such a trigger, citing the doctrine of independent legal significance. The Court's rejection of this defense was not just forceful, but it again brought home the role that skepticism about the board's priorities played in the Court's assessment:

> When merger consideration includes partial cash and stock payments, shareholders are entitled to appraisal rights. So long as payment of the special dividend remains conditioned upon shareholders approval of the merger, *Caremark shareholders should not be denied their appraisal rights simply because their directors are willing to collude with a favored bidder to "launder" a cash payment.*[113]

2. *The* Netsmart *Merger Litigation*

The Court's recent concerns about corporate management using a "going private deal" to line their pockets began with Vice Chancellor Lamb's rejection of a proposed settle-

111. *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1016 (Del. Ch. 2005) (the court does not "presume that all business circumstances are identical or that there is any naturally occurring rate of deal protection, the deficit or excess of which will be less than economically optimal.").

112. Louisiana Mun. Police Employees' Ret. Sys. v. Crawford, 918 A.2d 1172, 1188 (Del. Ch. 2007).

113. *Id.* at 1192 (footnotes omitted).

ment in *In re SS&C Technologies, Inc. Shareholders Litig.*[114] In that case, the Court admonished boards to be especially vigilant with respect to their chosen sales process, in light of the temptations and possibilities for mischief that going private deals provide to management.

The Court elaborated upon its focus and concern in this context in *In re Netsmart Techs, Inc. S'holders' Litig.*[115] In *Netsmart*, the Court enjoined a shareholder vote on a going private deal to require additional disclosures, and found a reasonable likelihood of fiduciary breaches arising in a flawed corporate sales process. The opinion focuses squarely on evidence that self-interested management may have tilted the board's process to ensure that the company was sold to private equity buyers, thus increasing the likelihood of an immediate payout (through triggering the senior executives' golden parachutes) along with greater payouts down the road (through those same senior executives negotiating rich equity compensation packages for their continued employment with the private entity). Vice Chancellor Strine explained the flaw in the board's sales process as follows:

> Relying on the failure of sporadic, isolated contacts with strategic buyers stretched out over a course of more than a half-decade to yield interest from a strategic buyer, *management. . . steered the board away from any active search for a strategic buyer. Instead, they encouraged the board to focus on a rapid auction process involving a discreet set of possible private equity buyers. . .*
> As in most private equity deals, Netsmart's current executive team will continue to manage the company and will share in an option pool designed to encourage them to increase the value placed on the company in the Merger.[116]

The plaintiffs in that case also argued that besides seeking to line their own pockets with private equity wealth, "Netsmart's management only wanted to do a deal involving their continuation as corporate officers and their retention of an equity stake in the company going forward, not one in which a strategic buyer would acquire Netsmart and possible oust the

114. 911 A.2d 816, 820 (Del. Ch. 2006).
115. 924 A.2d 171 (Del. Ch. 2007).
116. *Id.* at 175.

incumbent management team."[117] Thus, the presence of the same "omnipresent specter" that inspired *Unocal* played a role in the Court's analysis.

Notably, the Court's skepticism was not theoretical only. Rather, the plaintiffs actually presented evidence showing the greed was at play. After discussing a slide presentation made by senior management to the board outlining their strategic options, the Court noted that:

> Interestingly, another version of this same slide contained another bullet adding 'Second bite at the apple' to the list of benefits in a private equity deal. This reference obviously refers to the potential for management to not only profit from the sale of its equity (including exercising options) in the going private transaction itself, but from future stock appreciation through options they were likely to be granted by a private equity buyer, a class of buyers that typically uses such incentives to motivate management to increase equity value.[118]

Thus, at the core, the Court was concerned not so much with "what they did", but rather with "why they did it," *i.e.*, the Court was troubled with the intent, rather than the effect. For example:

> In what was to be the pattern throughout, the Netsmart side of the due diligence process was handled by company managements with little involvement from the Special Committee or its advisors. *This occurred despite the fact that Netsmart management was keenly interested in the future incentives that would be offered by buyers, including what, if any, option pool would be offered to them in the resulting private company.* Given its lack of participation in this process, the Special Committee had virtually no insight into how consistent management was in its *body language* about Netsmart's prospects to the various private equity firms in the process.[119]

117. *Id.* at 176.
118. *Id.* at 181-82 (footnote omitted).
119. *Id.* at 188.

The self-interested motivations at play in *Netsmart*, which one plaintiff called the "Golden Bungee Jump" in a subsequent case,[120] is the common element in all of the "going private" cases that resulted in a shareholder ruling, while the absence (or relative absence) of this phenomena was key to director rulings. Thus, rather than interpreting Vice Chancellor Strine's opinion in *Netsmart* as a change or revision to some "blueprint" for how board's should and should not act when selling the corporation, perhaps the case stands for the simple, but critical proposition that although the effects of a certain course of conduct may or may not harm shareholders in different circumstances, the Court will not be shy in asserting its authority to protect shareholders when the *intent* behind that process is in question. Indeed, after detailing the technical and procedural failings of the Netsmart board (and rejecting some of the plaintiffs' arguments as well), the Court summed up the *Revlon* analysis with a return to intent and motive:

> *In this regard, a final note is in order. Rightly or wrongly, strategic buyers might sense that CEOs are more interested in doing private equity deals that leave them as CEOs than strategic deals that may, in this case, certainly, would not.* That is especially so when the private equity deals give management, as Scalia aptly put it, a "second bite at the apple" through option pools. . . .
> Here, while there is no basis to perceive that Conway or is managerial subordinates tilted the competition among the private equity bidders, *there is a basis to perceive that management favored the private equity route over the strategic route.* Members of management desired to continue as executives and they desired more equity. A larger strategic buyer would likely have had less interest in retaining all of them and would not have presented them with the potential for the same kind of second bite. . . .[121]

The problems with the process in *Netsmart* may not have been considered problems under different facts. Rather, it appears the process was viewed negatively because of the evi-

120. *See* Minneapolis Firefighters' Relief Ass'n v. Ceridian Corp., Civ. A. No. 2996-CC, Amended Class Action Complaint, ¶3.

121. *In re* Netsmart Techs., Inc. S'holders Litig., 924 A.2d 171, 198 (Del. Ch. 2007).

dence suggesting that fiduciaries (in this case senior officers) used their corporate powers to manipulate or taint a board's process (and the board was all too willing to let that happen by taking a passive role in the negotiations and due diligence.[122]

Just as no discussion of *Caremark* can pass without reference to the ruling on appraisal rights, our discussion of *Netsmart* must address the basis for the injunction, which was the defendants' failure to disclose the projections on which the investment advisors' opinion and discounted cash flow analysis rested. Vice Chancellor Strine's ruling on this point seemed to set a sensible and clear rule of disclosure, although the last sentence below arguably incorporated a view towards motive as a factor in deciding what need and need not be disclosed:

> Faced with the question of whether to accept cash now in exchange for forsaking an interest in Netsmart's future cash flows, Netsmart stockholders would obviously find it important to know what management and the company's financial advisor's best estimate of those future cash flows would be. . . It would therefore seem to be a genuinely foolish (and arguably unprincipled and unfair) inconsistency to hold that the best estimate of the company's future returns, as generated by management and the Special Committee's investment bank, need not be disclosed when stockholders are being advised to cash out. *That is especially the case when most of the key managers seek to remain as executives and will receive options in the company once it goes private.*[123]

122. In this regard, the parallels between the recent going private deal cases and the lesson of *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1988) are stark. Here, as there, the board majorities are not directly conflicted and are typically independent. Nevertheless, their relegation of too much trust and power in one or a small number of conflicted insiders creates a situation where the misdeeds of one fiduciary may taint the entire board process. *Id.* at 1279 ("judicial reluctance to assess the merits of a business decision ends in the face of illicit manipulation of a board's deliberative processes by self-interested corporate fiduciaries. Here, not only was there such deception, but the board's own lack of oversight in structuring and directing the auction afforded management the opportunity to indulge in the misconduct which occurred.").

123. *Netsmart*, 924 A.2d at 171 (footnote omitted).

Although a fair reading of *Netsmart* would suggest that a black line rule of disclosing the projections used to support the banker's analysis was established, within the following six months, however, the Court twice distinguished this aspect of Vice Chancellor Strine's opinion. In *In re Checkfree Corp. Shareholders Litig.*,[124] the Chancellor held that a seven page summary of the basis for a Goldman Sachs fairness opinion was sufficient even without the management projections that supported the opinion.[125] The latter ruling distinguished *Netsmart* by focusing on the "partial" disclosure of some projections in that case, while the Goldman disclosures at issue in *Checkfree* never disclosed any projections and highlighted that Goldman had to test their validity by questioning senior management about them.[126] This does not really address Vice Chancellor Strine's above-quoted point about disclosing management's "best estimate" of future value, and basically rewards a "less is more" theory of disclosure. Perhaps the most logical way to reconcile these rulings is with the Chancellor's finding that the projections at issue in *Checkfree* were "raw" and "admittedly incomplete."[127]

Within a month, Vice Chancellor Parsons seemed to have reconciled these two opinions just this way in *Globis Partners, L.P. v. Plumtree Software, Inc.*,[128] in which the plaintiff sought money damages (post-closing) for, among other things, a failure to disclose management's projections. The Court rejected the argument as follows:

> This court has found omissions of certain projections of corporations' future profits to be material if they were reliable. Conversely, unreliable projections may in fact be misleading. In explaining why Jefferies considered a Discounted Cash Flow analysis inappropriate for its valuation, Plumtree stated it only had "very limited intermediate and long-term visibility." Plaintiff does not allege Plumtree in fact had reliable projections or any other facts that reasonably would call into question the veracity or adequacy of this as-

124. No. 3193-CC, 2007 WL 3262188 (Del. Ch. 2007).
125. *Id.* at *2-3.
126. *Id.*
127. *Id.*
128. No. 1577-VCP, 2007 WL 4292024 (Del. Ch. 2007)

> pect of disclosure. Rather, Globis' Complaint focuses more on challenging Jefferies' judgment that the available forecasts were unreliable and unhelpful. Such criticisms do not constitute a sufficient basis for a breach of disclosure claim.[129]

3. *The* Topps *and* Lear *Merger Litigations*

After asserting jurisdiction to hear the Delaware plaintiffs' motion to preliminarily enjoin the closing of the Topps going private deal, on June 14, 2007, Vice Chancellor Strine published his opinion on the matter.[130] In *Topps*, a private equity group led by former Disney CEO Michael Eisner agreed to pay $9.75 per share to take the well-known baseball card maker private.[131] Since Eisner refused to allow his offer to wait for a board-run auction process, the merger agreement contained a "go shop" provision that allowed the board to shop the bid for 40 days after signing the merger agreement, with a two-tiered termination fee linked to when the competing bid, if any, emerged.[132]

The case raised interesting issues about a board's duty to facilitate a competing bid when long-time competitor The Upper Deck Company subsequently offered a conditional $10.75 per share.[133] Because of a standstill agreement that the Topps board made Upper Deck sign during the 40 day "go shop" period, Upper Deck was unable to circumvent the board by taking its offer direct to shareholders and the Topps board refused to grant a requested waiver of the standstill.[134]

Had the court applied a traditional interpretation of the *Revlon* standard, it could have said that the process employed

129. *Id.* at *13 (internal citations omitted). The Court also noted how the difference in procedural posture (*i.e.*, injunction vs. post-closing review) can affect the substantive rulings. *Id.* at *10 ("Delaware courts have stated a preference for having this type of proxy-related disclosure claim brought as one for a preliminary injunction before the shareholder vote, as opposed to many months after. . . . This preference stems from the inherent difficulties in fashioning an appropriate remedy for disclosure violations significantly after the fact.")

130. *See In re* The Topps Co. S'holders Litig., 926 A.2d 58 (Del. Ch. 2007).

131. *Id.* at 61.

132. *Id.*

133. *Id.* at 62.

134. *Id.*

by the Board was generally reasonable, that the board was generally independent of management, and that shareholders could not second-guess otherwise legitimate judgments. But consistent with the more open assessment of the motives underlying board conduct (and the recognition that even one fiduciary officer or director can taint the entire board process), the Court parsed the board's supposed justifications for rejecting Upper Deck despite the higher offer with a fair deal of cynicism.

Early in the negotiations between Eisner and Topps Chairman and CEO Arthur Shorin (a member of the Topps founding family), Eisner offered to be "helpful" in Shorin's troubles with activist and discontent shareholders threatening a second round of proxy fights for board control.[135] Soon after negotiations about a possible deal started, "Eisner bid $9.24 in a proposal that envisioned his retention of existing management, including Shorin's son-in-law."[136] This subtle point clearly struck a chord with the Court, which articulated the *Revlon* standard as follows:

> Of particular pertinence to this case, when directors have made the decision to sell the company, any favoritism they display toward particular bidders must be justified *solely by reference to the objective of maximizing the price the stockholders receive for their shares.* When directors bias the process against one bidder and toward another. . . to tilt the process toward the bidder more likely to continue current management, the commit a breach of fiduciary duty.[137]

After approving the deal protections on the basis that their effects were not overly preclusive or coercive,[138] the

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135. *Id.* at 61.

136. *Id.*

137. *Id.* at 64. Here, as in the Supreme Court's ruling in *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1988), the Court takes an entire board to task for "tilting" the playing field when it is really one or a small number of fiduciaries that do the tilting, while the board is being criticized for letting that opportunity for mischief exist.

138. One aspect of the Court's analysis of the reverse termination fee is worth note. The court observed that "financial buyers" seek to limit their liability to reverse termination fees because, in light of "reputational factors," they are considered a "lower risk of consummation for lack of financing than strategic buyers." *Topps*, 926 A.2d at 72 n.11. Those financial buyers should

Court ruled that the board had failed to disclose adequately Eisner's communications with Topps management.[139] Notably, Eisner had not actually signed any agreements with Topps management, and defendants surely made that point here (and in prior periods may well have been successful with this pitch). But the Court found the company's disclosure, including the proxy's highlighting of the board's instruction to management not to negotiate employment arrangements until a merger agreement was signed, to be inadequate.[140] The Court viewed the disclosure misleading because, whether or not agreements had been negotiated, Eisner explicitly stated that his proposals were "designed to" retain "substantially all of [Topps'] existing senior management and key employees."[141] The Court, in rejecting these technically true disclosures, stated that shareholders were given the false "impression that Topps' managers have been given no assurances about their future by Eisner."[142]

The Court's focus on how a key insider's personal motives can affect an entire corporate sales process also played a key role in *In re Lear Corp. Shareholders Litig.*,[143] an opinion issued the day after *Topps*. In *Lear*, the "background of the merger" section of the proxy statement was held to be incomplete because it failed to disclose background facts necessary to weigh the target company's CEO's potential bias favoring a buyout:

> [T]he Special Committee employed the CEO to negotiate deal terms with Icahn. But the proxy statement does not disclose that shortly before Icahn expressed an interest in making a going private offer, the CEO had asked the Lear board to change his employment arrangements to allow him to cash in his retirement benefits while continuing to run the company. . . .
>
> Because *the CEO might rationally have expected a going private transaction to provide him with a unique means to*

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tell that story to the shareholders or United Rentals, Inc., Harmon International, Inc. and Sallie Mae, each of which saw acquisitions scuttled by financial buyers backing out of deals amidst the credit crisis of 2007-08.

139. *Id.* at 74.

140. *Id.*

141. *Id.*

142. *Id.*

143. 926 A.2d 94 (Del. Ch. 2007).

> *achieve his personal objectives*, and because the merger with Icahn in fact secured for the CEO the joint benefits of immediate liquidity and continued employment that he sought just before negotiating the merger, the Lear stockholders are entitled to know that *the CEO harbored material economic motivations that differed from their own* that could have influenced his negotiating posture with Icahn.[144]

This disclosure ruling is wholly consistent with a court focused squarely on "good faith" in the broadest sense, unconstrained by rigid concepts or standards.

One final note about *Topps* is worth further analysis. The Court took a welcome position in favor of shareholder value by challenging the board's indifference, if not outright hostility, towards Upper Deck's advances. The Board declined – at the end of the short 40-day "go shop" period, to declare Upper Deck an "Excluded Party," which would give the bidder and the board more leeway in assembling a deal competitive to Eisner's. "By declaring Upper Deck an Excluded Party, the Topps board would have preserved maximum flexibility to negotiate freely with Upper Deck. *The downside of such a declaration is hard to perceive*."[145]

The Court's theory for why the Topps board acted so stubbornly is notable. Although there was no hint that the CEO dominated the board or compromised its independence in the traditional sense, the Court correctly recognized the subtle influence an interested CEO can have in this type of situation:

> The record before me clearly evidences Shorin's diffidence toward Upper Deck and his comparatively much greater enthusiasm for doing a deal with Eisner. Eisner's deal is premised on continuity of management and involvement of the Shorin family in the firm's business going forward. Upper Deck is in the same business line and does not need Shorin or his top managers.[146]

The Court took issue with the board's refusal to grant Upper Deck a release from the standstill agreements. After ex-

144. *Id.* at 98 (emphasis added).
145. *Topps*, 926 A.2d at 89.
146. *Id.* at 91.

plaining that standstills "serve legitimate purposes" to the extent they "establish rules of the game that promote an orderly auction," the Court found that the board in this case was hiding behind the standstills for reasons not consistent with the good faith pursuit of the best outcome for shareholders:

> But standstills are also subject to abuse. Parties like Eisner often, as was done here, insist on a standstill as a deal protection. Furthermore, a standstill can be used by a target improperly to favor one bidder over another, not for reasons consistent with stockholder interest, but because managers prefer one bidder for their own motives.[147]

4. *The* Inter-Tel *Case and the Consolidation of the* Blasius *Standard*

While the *Caremark* case showed that the supposed distinction between *Time/Warner* and *Revlon* deals will not deter the Court from scrutinizing the motivations of directors, the "compelling justification" standard of *Blasius* also seemed to blur in importance with the Court's decision in *Mercier v. Inter-Tel (Delaware), Inc.*[148] The specific question in *Mercier* was whether a board could postpone a special shareholders meeting to vote on a proposed merger at the very last moment, where the shareholders were clearly going to reject the deal.[149] From a distance, this case should have been an easy one for shareholders – the corporation belongs to the shareholders, and only they can decide whether to sell their shares in a takeover deal. It is their prerogative to reject whatever proposal is made, and a board decision to delay a meeting just because the shareholders "don't get it" is unlikely to withstand whatever scrutiny is applied. The case did not, however, work out as expected.

The opinion reflects the parties' extensive arguments about whether the case should be decided under the very deferential business judgment rule, the reasonableness standard of *Unocal*, or the "compelling justification" standard of *Blasius*. This debate, though addressed in detail by the Court, arguably made no difference to the outcome, which rests almost entirely on the Court's careful assessment of the facts and its con-

147. *Id.*
148. 929 A.2d 786 (Del. Ch. 2007).
149. *Id.* at 786.

clusion that little or no evidence called into question the good faith of the board.

The core justification for the board's last-second maneuvering was the board's concern that shareholder rejection of the deal would cause the bidder to abandon the transaction. The Court upheld this conduct, effectively concluding that "well-motivated independent directors may reschedule an imminent special meeting at which the stockholders are to consider an all cash, all shares offer from a third-party acquiror."[150]

Mercier offers a new twist on the Court's focus on the underlying intent of the board. Specifically, in *Mercier*, the Court concluded, on a preliminary injunction record, that little or no evidence called into question whether the board supported the deal in good faith. Among other things, and unlike *Netsmart, Topps* or *Lear*, the opinion never suggests that the company's senior management may have tilted the board's deliberative process so they could line their own pockets, or that the board enjoyed some tangible benefit by protecting the favored transaction.

To the contrary, the opinion reflects a far greater concern that the deal's principal opponent – the company's founder and 19% stockholder Steven G. Mihaylo – was opposing the deal for personal reasons not consistent with shareholder welfare.[151] In particular, the Court took note of the board's seemingly well-intentioned efforts to appease Mihaylo, who did not respond in kind:

> Care was apparently taken to ensure that Mihaylo was approached in the most diplomatic and respectful manner. . . . But Mihaylo was not amenable, and raised a number of issues (such as concerns about the future of certain employees and of a company campus near his home) that reflected his unique (and understandable) perspective as a founder, rather than a focus on maximizing value for stockholders.[152]

150. *Id.* at 787.
151. *See, e.g.*, *id.* at 791 (noting possibility that founder was seeking repurchase of his shares by the board at a premium, *i.e.*, greenmail); *id.* at 791 n.9 (implying that bidding information was leaked by Mihaylo).
152. *Id.* at 794.

In a sense, *Mercier* can perhaps be viewed as the diametrical opposite of *Mills Acquisition Co. v. Macmillan, Inc.*, in which an otherwise properly functioning board process was tainted by the improper actions of an interested CEO.[153] In *Mercier,* the Court arguably found that one interested director – Mihaylo – effectively breached his fiduciary duty to maximize value, but credited the remainder of the board for protecting the shareholders from those breaches. And critically, the board's motive in acting to counter Mihaylo's interference was, based on the record, taken in good faith:

> Unlike the plaintiff, however, I find nothing in the record that suggests that the Special Committee had an improper motivation to delay the vote. None of the Special Committee members. . . had been promised any position with Mitel after the Merger, and each expected to lose his board seat upon approval. Put simply, *the Special Committee, on this record, must be viewed as supporting the Merger because they thought it was in the best interests of the Inter-Tel stockholders.*[154]

Besides the board having no reason to favor the deal to protect management or enhance their own positions, the opposition of one of the bidders to the postponement of the shareholder meeting also indicated that the board was not acting to benefit the buyers.[155]

The Court's discussion of the applicable legal standards – though not critical to the outcome of this particular case – sheds light on the movement away from fixed standards of review and towards a more organic "good faith" standard. Although the Vice Chancellor focused on how the Court would approach questions relating to corporate elections, his commentary could apply with equal force to any debate over which "standard" should apply:

> It would hardly be indiscreet for me to acknowledge yet again the widely known reality that our law has struggled to define with certainty the standard of review this court should use to evaluate director action

153. *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1988).
154. Mercier v. Inter-Tel, Inc., 929 A.2d 786, 795 (Del. Ch. 2007).
155. *Id.* at 797 ("Francisco Partners did not warm to the idea" of delaying the meeting to obtain more shareholder support).

> affecting the conduct of corporate elections. The results in the cases make sense, as the decisions do a good job of sorting between situations when directors have unfairly manipulated the electoral process to entrench themselves against insurgents and those when directors have properly used their authority over the election process for good faith reasons that do not compromise the integrity of the election process.[156]

Later, as if to bring home that the Court is moving towards a blending of all standards to the organic and more workable "good faith" standard, Vice Chancellor Strine roped in the other "standards" as well:

> Consistent with the directional impulse of [*MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003)], I believe that the standard of review that ought to be employed in this case is a reasonableness standard consistent with the *Unocal* standard. I recognize in so stating that some of the prior *Unocal* case law gave reason to fear that that standard, and the related *Revlon* standard, were being denuded into simply another name for business judgment rule review. More recent decisional law, one hopes, has been truer to the test as written, and our cases have universally recognized the need for close scrutiny of director action that could have the effect of influencing the outcome of corporate director elections or other stockholder votes having consequences for corporate control.[157]

V.
CONCLUSION

The desire for clearly-defined "standards of review" is understandable, particularly for corporate directors and their advisors. As history has shown time and again, however, while

156. *Id.* at 805.
157. *Id.* at 810 (internal citations omitted); *see also id.* at 812 n.79 ("The searching review used in MONY to get to the conclusion that the business judgment rule standard applied closely resembles a *Unocal* reasonableness review tailored to the electoral context. *In my view, it would be preferable to simply use such an inquiry as the prism for cases of this type.*").

most fiduciaries appreciate the predictability of firm and objective rules of judicial review so that they can navigate the waters with confidence that their good faith judgments will be protected from second-guessing, there are always some who seek to "game the system" by taking advantage of rigid rules.

The Chancery Court's recent rulings in both the option backdating context and the M&A field involved core questions of good faith and loyalty that may not have been an easy fit into the existing jurisprudential framework. With the spotlight on the Court from regulators, investors, corporate officials and advisors alike, the Court seems to have taken an open and pragmatic approach to considering the real underpinnings of corporate conduct. Reliance on flexible and undefined standards is a double-edged sword, as it places a greater premium on the fairness and dedication of trial judges whose rulings are more difficult to challenge when they are steeped in factual nuance. However, if the recent group of cases is any indicator, the Court is considering all angles and interpretations of the facts regarding the good faith of fiduciaries in an even-handed and open-minded way, before deciding whether the powerful effects of the business judgment rule attaches.

This is a welcome development for shareholders, who are seeing that when they raise a legitimate question about a fiduciary's good faith, the Court will be receptive to their arguments even if the allegations or evidence does not fit neatly into the existing decisional framework. The Court's deliberate and searching approach should also be welcome for directors, who see – as exemplified by the *Mercier v. Inter-Tel* ruling – that the Court will give them considerable leeway when the record indicates little reason to question their good faith.