Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*

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I am honored to present the Lawrence Lederman/Milbank, Tweed, Hadley & McCloy Seminar in Corporate and Business Law at the NYU Center for Law and Business. I appreciate the chance to be with you and to share in the warm hospitality afforded to me by Professor William T. Allen, Melissa Smith, and their colleagues at NYU.

The title of my lecture today is "Categorical Confusion: Deal Protection Measures In Stock-For-Stock Merger Agreements." Lest anyone think...


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that my intent is to clear up all the confusion surrounding deal protection measures, rest assured you are wrong.

I will take full advantage of the refuge afforded me by my judicial position. Nothing I say should or can be used against me in a court of law. My remarks will be consciously oblique.

Another warning is in order. I will leave much implicit. My assumption is that you are familiar with the fundamental concepts of Delaware mergers and acquisitions law.2

With those caveats out of the way, I'm going to dive right in. My aim is to explore some of the doctrinal tensions posed by the deal protection measures commonly contained in stock-for-stock merger agreements. To expose these tensions to daylight, I will center my discussion around a realistic hypothetical. In coming up with fictional company names, I tried to think like an investment banker and soon fixed on the names hungry wolf and legless bunny rabbit. But then I realized that cheap humor of that sort was beneath the dignity of a member of the Court of Chancery.

Assume instead two sedate publishing companies which are seeking to consummate a stock-for-stock merger (the Stock-for-Stock Merger or Merger). The first company is Zuckerman Industries. The second is Angstrom International.3 For purposes of this lecture, the listener should assume that the publishing industry is a rapidly consolidating one in which size and sales matter.

Assume also the following:

- Zuckerman and Angstrom are both publicly traded Delaware corporations. Neither has a controlling stockholder.
- Angstrom will be the surviving corporation in the Merger.


3. The author's apologies are extended to Philip Roth and John Updike. Although Nathan Zuckerman might be said to have some of the attributes of a hungry wolf, the late Harry "Rabbit" Angstrom was anything but "legless."
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- The stockholders of Zuckerman give up their shares in exchange for shares of Angstrom.
- Delaware law requires that the Merger receive the assent of the stockholders of at least Zuckerman.4
- After the Merger, Angstrom will not have a controlling stockholder.

Thus, the transaction does not invoke Revlon duties on the part of Zuckerman’s directors.5

Of course, the title of this lecture would be a misnomer if the Zuckerman-Angstrom Merger Agreement did not contain some deal protection measures. Before describing those measures, however, I pause to define the term “deal protection” measure.

What I mean by that term are those features of merger agreements that are protective in two related senses. The first sense is that they provide some economic compensation to the jilted party in the event that the other

4. This feature of the Merger Agreement is critical. Because the Stock-for-Stock Merger cannot be approved by the Zuckerman directors acting unilaterally, an element of transactional and legal risk is present. In reaction to its fear that the Zuckerman stockholders might not approve the transaction, Angstrom might demand, for example, a high termination fee triggered by a no vote. But because Delaware law has historically placed a high value on the free exercise of the stockholder vote, there is a risk that the high fee might be seen as unduly penalizing a no vote, and be struck down as coercive and invalid. The extent of this risk may differ depending on the standard of judicial review that governs the Zuckerman directors’ decision to accede to the high fee.

The fact that the Merger will have to be put to a vote creates other issues. That vote will be preceded by disclosures by the Zuckerman directors that must adequately inform the Zuckerman stockholders of the facts material to their decision whether to approve the Merger. Traditionally, such disclosures have contained a recommendation by the board in favor of the Merger and the reasons buttressing that recommendation. Because of the lag time that is likely between the time the Zuckerman directors approve the Merger Agreement and the stockholder vote, Angstrom faces the risk that material events may occur that make it difficult for the Zuckerman directors to continue to recommend the Merger. But if Angstrom attempts to confine that risk by extracting an agreement from the Zuckerman board not to talk to rival bidders under any circumstances and to recommend the Merger regardless of new developments, it has generated litigable issues, the outcome of which may depend on the applicable level of judicial scrutiny.

5. E.g., Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994); Paramount Communications, Inc. v. Time, Inc., Cons. C.A. No. 10670, 1989 WL 79880, at *25 (Del. Ch. Jul. 14, 1989) (Allen, C.), aff’d, 565 A.2d 280 (Del. 1989), op. issued, 571 A.2d 1140 (Del. 1989). Because the Merger is a stock-for-stock merger that will not vest control of Angstrom in a controlling stockholder, the Merger is not considered a “change of control” transaction in which the stockholders of Zuckerman are entitled to a control premium. Rather, because post-Merger control of Angstrom will rest in a disaggregated group of public stockholders, Delaware law presumes that the Zuckerman stockholders will have a chance at a control premium down the line and need not be provided one now. QVC, 637 A.2d at 42-43. Put bluntly, that means that the directors of Zuckerman can support the Stock-for-Stock Merger if they believe it is the correct long-term strategy for the company even if the Stock-for-Stock Merger will not yield the highest price that could be obtained right now.
party to the deal chooses not to consummate it. The second sense in which deal protection measures are protective is that they obstruct disruption of the deal by another transaction. The two ways in which deal protection measures are protective reinforce each other. The more formidable the barrier the deal protection measures erect against other bidders, the more likely it is (absent judicial invalidation of the measures) that the transaction will in fact take place and thus no compensable harm will be suffered.

6. For example, merger agreements typically contain a termination fee requiring the corporation which causes the merger not to be consummated to pay a sum of money to the other party to the merger as compensation for the costs and lost opportunities suffered as a consequence of its investment in a transaction that did not come to fruition.

7. Classic examples of deal protection measures of this sort are no-shop or no-talk clauses. These clauses contractually bar the signatory board of directors from taking steps to facilitate another transaction. Likewise, termination fees frequently have a purpose that is also protective in this defensive sense. E.g., Stephen R. Volk et al., Negotiating Business Combinations—The Sellers Point of View, 33 SAN DIEGO L. REV. 1077, 1110-11 (1996) (“Break-up fees and lock-up stock options make it more expensive for a third party to compete with the original acquiror. The third party not only must pay the stockholders for their shares, but also must bear the cost of the transaction protection devices. This may skew the playing field in favor of the original acquiror. . . .”). Thus, many merger agreements require that a higher termination fee be paid when the corporation which has caused non-consummation has entered into an alternative transaction. Merger agreements have also often contained stock options that had no economic utility to the party receiving the option as an optionee. But the options had great utility as a defensive measure because they destroyed the ability of rivals to obtain “pooling of interests” accounting treatment for any alternative transactions. E.g., id. at 1118-19 (“With respect to a third party with a perceived need to employ ‘pooling of interests’ accounting, the existence of a stock option lock-up arrangement may also carry significant deterrent value. The exercise of the option may prevent such third party from using pooling of interest accounting.”). With the looming abolition of pooling treatment itself, these options may soon be a thing of the past.

8. That the directors of Zuckerman are not forced to look at their options through the uni-dimensional Revlon lens also has implications for the deal protection measures that the board can agree to in negotiating with Angstrom. If the proposed Stock-for-Stock Merger were covered by the Revlon doctrine, the board could only agree to those measures if they were consistent with the board’s fiduciary obligation to maximize the immediate value Zuckerman stockholders would get in the deal. In metaphorical “Revlon-land,” the board could not accede to deal protection measures that would lock-up a deal that had great long-term potential from the board’s perspective if the measures would make it impossible for the board to accept a materially higher current value bid from another party. To put the point in a more direct way, unless the board’s financial advisors can opine, or the board in its own informed judgment can conclude, credibly that the long-term value of a strategic option has a higher present economic value than other offers, the board is not, as a general proposition, free to choose that option if Revlon duties have been invoked.

Outside of Revlon-land, however, the Zuckerman directors may legitimately take steps to secure a strategic merger that they in good faith believe will deliver excellent long-term results. Although how far a board may go in locking-up such a merger is to some degree uncertain, for now the important and settled point is that a board has markedly more flexibility to protect a non-Revlon stock-for-stock merger than it does to protect a transaction invoking Revlon duties.
For today's purposes, assume that Angstrom has secured the following deal protection measures from Zuckerman:

- a no-talk that forbids Zuckerman from having discussions with any other party during the term of the Merger Agreement;
- a termination fee payable in the event that Zuckerman does not go through with the Merger for any reason, including a negative stockholder vote;
- a stock option with the primary purpose of destroying "pooling of interests" accounting treatment for another bidder; and
- the right to match any superior offers made to Zuckerman.

Although not transactionally specific, also assume that Zuckerman has a poison pill in place. Suppose further that the Zuckerman charter eliminates any opportunity for stockholders to remove directors by written consent.

My central purpose today will be to use this basic hypothetical to demonstrate the difficulty of using rigid doctrinal boxes as a method of determining the validity of deal protection measures in different contexts. The questions I raise may suggest an inescapable need for the law to deal with the complexities of deal protection measures in a more supple way.

In particular, I will use variations on the hypothetical to raise the following questions:

One, what do the default provisions of Delaware law suggest about how courts should scrutinize deal protection measures?

Two, how does the Time-Warner decision affect the deference that a court must accord to a board's decision to agree to deal protection measures in a typical stock-for-stock merger agreement?

Third, how appropriate is it to use the QVC change of control test to determine what level of judicial scrutiny should apply to deal protection measures?

Fourth, what does the Delaware Supreme Court's decision in Quickturn suggest about a board's ability to agree to deal protection

9. Varallo & Raju, supra note 1, at 1615 ("Often, options are used primarily to make pooling of interests accounting treatment more difficult or unavailable for any third party."); Rowe, supra note 1, at 6 n.10 ("The key effect of equity cross-options has been to make it difficult or impossible for an overbidder to use pooling accounting, which can give the initial transaction a decided advantage over a subsequently-proposed deal.").

10. I do not use this occasion to focus on the tension between fiduciary duty law and contract law raised by deal protection measures. For a lucid discussion of these issues that makes clear that this tension operates outside of the corporate law context, see Regan, supra note 1, passim. The reader should note the author's recognition of the tension and of the need for the corporation law, as a general matter, to acknowledge the enforceability of merger contracts.


terms that disable it from considering other strategies for the company?

Fifth, is deferential judicial review of deal protection measures the appropriate way to reduce the risk that erroneous after-the-fact judicial decisions will diminish the overall number of worthy strategic transactions?

Finally, does judicial deference to an uncoerced shareholder vote reconcile the arguably inconsistent themes of the Time-Warner, QVC, and Quickturn decisions?

THE DEFAULT RULE UNDER THE DELAWARE GENERAL CORPORATION LAW: THE FIRM MAY BE SOLD IF STOCKHOLDERS AGREE TO SELL

Any informed discussion of merger deal protection measures must acknowledge the default rules of the Delaware General Corporation Law. These rules permit stockholders to accept a tender offer and sell control of the company in the minimum number of days permitted under the federal securities laws.¹⁴ Similarly, absent a certificate provision to the contrary, Delaware law permits stockholders to call a special meeting and elect a new board in thirty-five days.¹⁵ Put simply, statutory law itself presents no barrier to a tender offeror who wishes to deal directly with the stockholders of a Delaware corporation.

Note how differently the Zuckerman stockholders are positioned in the hypothetical than they would be under the default rules of Delaware law. They find themselves with an enormous number of obstacles between themselves and a willing buyer of all their shares.

Practitioners often (and judges sometimes) lose sight of the default rules of Delaware law. Recently, one sophisticated practitioner voiced the view that the Court of Chancery’s emphasis on “free shareholder votes” had a “dark side.” That dark side was that this emphasis “suggests shareholders should have independent affirmative as well as negative power with respect to extraordinary transactions.”¹⁶

That reasoning of this kind can be described as mainstream reflects the extent to which it has become common to assume that each Delaware corporation has as its birthright a shareholders rights plan and other defensive measures that imbue the corporation’s directors with the power to control when the corporation will be sold. More than a trifle turns on a recognition of first principles at odds with this assumption.

¹⁴. This period could conceivably be as short as twenty business days. See Coates, supra note 1, at 852-853 & n.91 (citing the relevant federal authorities).
¹⁵. Id. at 854 n.96.
¹⁶. Rowe, supra note 1, at 10.
That the foundation of our system of corporate governance—the Delaware General Corporation Law—accords stockholders significant flexibility to alienate their shares as a class is important in considering director action to limit that flexibility. Like any other director action, such defensive actions must be justified as the acts of properly motivated and informed fiduciaries.

Put another way, under the default rules of the DGCL shareholders do have “affirmative . . . power with respect to [at least one] extraordinary transaction”[17]—the transfer of control of a company through a tender offer. That “ownership” power is enormously valuable to stockholders.

As a practical matter, the ability of investors to sell may be their most important protection. Although the right to vote shares is significant, investors for the most part own stock to make money. That they want a fair opportunity to take advantage of favorable tender offers that might be available if all the stockholders may sell at once can be taken as a given.[18]

In the early 1980s, Delaware was forced to choose between two competing models as to how corporation law should address contests for corporate control. One model gave primacy to the stockholders’ right to react to tender offers without substantial target board involvement. The other model was director-centered and empowered boards to mediate between the stockholders and interested buyers of their shares.[19]

As we all know, the director-centered model won out. But the Delaware courts were quite cautious when choosing this model. For example, when the astounding innovation of the poison pill was sanctioned by the Delaware courts in Moran,[21] it was on the express understanding that the directors of a corporation would have to justify not only their adoption of the pill in the first instance but their use of the pill in the heat of battle. Not only that, they would have to do so under the heightened Unocal standard.[22]
Of course, humanity has a wonderful tendency to domesticate the outlandish, to reduce yesterday’s novelty to today’s banality. This tendency manifests itself in corporation law. By the 1990s, what was once shockingly novel—the poison pill—had become commonplace and unremarkable.

But it cannot remain unremarked upon. The omni-presence of poison pills must influence any profound consideration of deal protection measures. Deal protection measures do not operate in isolation from other defensive measures; they operate in tandem with them.

When directors like those at Zuckerman with a pill and other formidable defenses already in place decide to enter into a merger contract with strong deal protection measures, they are deepening their own role as their stockholders’ market intermediary. Having already arrogated to itself the ability to choose which tender offers their stockholders may accept (through the adoption of the pill), the Zuckerman board has then (by adopting the deal protection measures) acted to make it more difficult for itself—and therefore for the stockholders—to do other than consummate the Merger the board has selected as its preferred strategy for the corporation.

Such a decision places the stockholders in a position that is radically different from that they occupy under the default rules of Delaware law. Because that change in position was caused by the stockholders’ own fiduciaries, those fiduciaries should expect that the propriety of their actions will be subject to careful judicial review. After all, it is they who have changed the natural order of things.

THE QVC CHANGE OF CONTROL TEST: ARE THERE PRACTICAL LIMITATIONS ON THE USE OF THIS DOCTRINAL BOX TO ADDRESS UNCERTAINTY IN M&A DECISIONMAKING?

Having taken a director-centered approach to M&A, Delaware should have anticipated that it would face pressure to review director conduct in experience has shown that pills can be used in justifiable ways, but the central point remains: the Delaware courts could not have authorized the use of the pill without retaining the authority to hold directors responsible for its properly-motivated use. Otherwise, Delaware corporation law could have become untenably unbalanced and less legitimate.

23. See R. Franklin Balotti & J. Travis Laster, Professor Coates Is Right. Now Please Study Stockholder Voting, 54 U. MIAMI L. REV. 819 (2000) (“We live today in the Poison Pill Era. The stockholder rights plan, commonly known as the ‘poison pill,’ has profoundly affected every aspect of mergers and acquisitions practice. In the days before poison pills, boards of directors faced with tender offers could do little more than exhort their stockholders not to tender or cobble together a transactional alternative. The board had no direct role in the process. Now, armed with a pill, a board of directors can interpose itself between the target corporation’s stockholders and the offeror and prevent the acquiror from buying shares. Put simply, a board with a pill has the power to block a tender offer.”).

24. The Delaware courts have traditionally been willing to more closely scrutinize board decisions that have the effect of influencing so-called “ownership” issues rather than “enterprise” issues. See, e.g., Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 147 n.47 (Del. 1997).
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the M&A context as deferentially as possible. After all, Delaware corporation law generally takes an enabling approach that permits directors wide discretion to act on behalf of the corporation. But this freedom comes with its own implicitly stated check—litigation over whether the directors were properly motivated and sufficiently informed.

This check is an insubstantial consideration to directors in their day-to-day management of the firm. Absent their decision to engage in a self-dealing transaction, directors know that it is incredibly unlikely that their ordinary managerial decisions will be disturbed by Delaware courts. The business judgment rule guarantees this result.

But the business judgment rule does not operate with the same force in all areas of director decision-making. For now, most important is the fact that directors will face enhanced judicial scrutiny when they: (i) propose to sell the firm for cash or in any other transaction that would represent a change in control; or (ii) take actions designed to insulate

25. *QVC*, 637 A.2d at 42. The *Revlon* principle grows out of the traditional principle that fiduciaries must sell trust assets for their highest value. See Laster, supra note 1, at 206 (citing Paramount Communication, Inc. v. Time, Inc., Cons C.A. No. 10670, 1989 WL 79880, at *25 (Del. Ch. July 14, 1989)); accord *City Capital*, 551 A.2d at 802; Freedman v. Restaurant Assocs. Indus., Inc., C.A. No. 9212, slip op. at 17 (Del. Ch. Oct. 16, 1987); Wilmington Trust Co. v. Coulter, 200 A.2d 441, 448 (Del. 1964); Robinson v. Pittsburgh Oil Refining Corp., 126 A. 46, 49 (Del. Ch. 1924)). In its simplest formulation, *Revlon* requires directors who wish to sell the company for cash to take affirmative steps to obtain the highest sale price reasonably attainable. These duties also apply when the directors of a corporation without a controlling stockholder propose to engage in a transaction—that will vest controlling power in a single stockholder or control group. Why? Because after such a transaction, the minority stockholders may only receive a control premium through the grace of the new controlling stockholder. Thus, the transaction leading to the transfer in control is thought to represent the current stockholders’ last chance to receive a control premium and therefore to justify the requirement that the board focus on immediate, rather than long-term value, regardless of whether the transactional consideration is stock and not cash.

Although noted previously, once directors have entered the metaphorical world of *Revlon*, all of their actions will be judged against the singular objective of securing the best immediate value. As a practical matter, that means that the directors cannot give lock-ups or other preferences to one bidder if that will have the effect of deterring a sale of the company at the best price. It also means that the directors cannot prefer one deal over another because they believe that a buyer offering a, say, ten percent lower price has a long-term business plan that is better for other corporate constituencies, such as the employees. In *Revlon*-land, the directors must take a materially higher price because the law considers there to be no long-term for the corporation’s stockholders and thus their interests as owners in maximizing their final return from their investment is regarded as legally paramount. Because of *Revlon*’s uni-dimensional focus, the standard cabins director flexibility more than any other. While Delaware courts still accord directors substantial leeway to determine how to fulfill their duty to get the best deal, at bottom the standard reduces the directors to faithful auctioneers.

In practice, the *Unocal* and *Revlon* standards of review have much in common. Most *Revlon* cases focus primarily on the question of whether the board has impeded the emergence of an offer superior to the transaction favored by management, most notably by granting preclusive lock-ups to a favored bidder. See, e.g., *Barkan* v. Amsted Indus., Inc., 567 A.2d 1279 (Del. 1989); *Matador Capital Management Corp. v. BRC Holdings, Inc.*, 729 A.2d 280 (Del.
the corporation from the threat of an unsolicited acquisition proposal.\textsuperscript{26}

Supple minds resist the reasoning away of difficult problems on the basis of logically unsustainable dividing lines. But the practical need for reasonable certainty often pushes us towards just this sort of problem-solving approach. For M\&A practitioners prospecting for \textit{terra firma}, the \textit{QVC} change of control test can be dangerously appealing in precisely this respect. If a merger transaction is shaped to fall outside the definition of a change in control transaction invoking \textit{Revlon} duties,\textsuperscript{27} some practitioners hope that any deal protection measures in the merger agreement\textsuperscript{28} will be reviewed under the deferential business judgment rule standard of review rather than the relatively more stringent \textit{Unocal} standard.\textsuperscript{29}

As these aggressive practitioners would have it,\textsuperscript{30} transactions that in economic substance are virtually indistinguishable should be subject to

1998); McMillan v. Intercargo, Corp., C.A. No. 16963, 2000 Del. Ch. LEXIS 70 (Del. Ch. Apr. 20, 2000) (Strine, V.C.); Goodwin v. Live Entertainment, Inc., C.A. No. 15765, 1999 WL 64265 (Del. Ch. Jan. 25, 1999) (Strine, V.C.). That is, much of our \textit{Revlon} case law can be viewed as the application of \textit{Unocal} in a situation in which the only benchmark of reasonableness is whether the lock-up advances or impedes the attainment of the best immediate value.

But the one major difference is important. When \textit{Revlon} duties are not invoked, the directors have no obligation to deliver the highest immediate value to stockholders. Therefore, the directors may legitimately favor a corporate strategy that they believe will result in greater gain over the long-term over a competing strategy that might deliver higher immediate returns. This reality necessarily gives a board a great deal more flexibility to protect transactions because the board can point to what it sees as the unique synergistic benefits from their favored deal as justifying its decision to lock-up the deal as tightly possible and to eschew other transactions. Because Delaware courts are extremely reluctant to second-guess decisions like this, a board operating in this \textit{Unocal} environment has substantially more leeway than a board subject to \textit{Revlon} duties.

26. This form of heightened \textit{Unocal} scrutiny is invoked when a board takes measures to deter or prevent a hostile acquisition offer. Put simply, the \textit{Unocal} standard requires the board to demonstrate that its defensive measures are reasonably proportionate to the threat the corporation faces. See Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1379 (Del. 1995). The justification for this unusual inquiry into the reasonableness of the directors' decisions is the perception that corporate management may have a variety of motives to oppose a takeover that have nothing to do with shareholder value. \textit{Unocal}, 493 A.2d at 955. As a result, there is thought to be a need to ensure that even subjectively well-intentioned directors do not wrongly prevent stockholders from receiving genuinely worthy offers.

27. See Gilson & Kraakman, supra note 1, at 46 ("Precisely because both parties in a friendly transaction hope to avoid opening the field to competitive bids, there is an incentive to cooperate in casting the transaction in a form that does not trigger \textit{Revlon}").

28. Nothing in this speech should be construed as proposing that courts should give "heightened scrutiny" to the basic economic terms of a merger agreement to determine whether the transaction is a good or better deal. Rather, this speech solely examines questions surrounding the level of judicial scrutiny that should be given to the defensive measures or "deal protections" contained in the merger agreement.

29. See, e.g., Rowe, supra note 1, at 1, 14.

30. I do not use the term aggressive in any negative way. The law's evolution depends on intelligent and zealous (i.e., thoughtfully aggressive) advocacy by lawyers, and many of the lawyers who argue for business judgment rule review of deal protection measures are among the most capable and effective in the legal profession.
vastly different forms of judicial review solely because those transactions fall out on one side or the other of the *QVC* test. That is, although the economic nature of merger transactions themselves will tend to differ in incremental and marginal ways, aggressive practitioners see the optimal approach to judicial review as involving the division of the M&A world into two stark transactional categories: (i) *Revlon* deals in which deal protection measures will be scrutinized under *Revlon* and *Unocal*, and (ii) non-*Revlon* deals in which deal protection measures will be subject to business judgment rule review.

But is this dichotomy logically sustainable? Let’s look at a few variations on the basic Zuckerman and Angstrom hypothetical. Assume for a moment that Angstrom is a huge publishing corporation with a market capitalization that is five times that of Zuckerman and that it has plenty of unissued stock it can use as acquisition currency. Further assume that Zuckerman’s operations will be consolidated into one of Angstrom’s divisions. Assume that all the deal protection measures previously identified are in place and that the termination fee Zuckerman has agreed to pay is equal to 7.5% of its equity value, which will be triggered in the event that its stockholders vote no.

In these circumstances, the Stock-For-Stock Merger would not invoke *Revlon* duties on the part of the Zuckerman board even though the transaction is essentially a straightforward acquisition and not a merger of equals.\(^3\) According to the world view of aggressive practitioners, however, the potent deal protection measures contained in the merger agreement would not be reviewable under *Unocal* but only under the business judgment rule.

Now change the hypothetical only slightly in economic terms. Assume that the transaction is identical in all respects except that the Zuckerman stockholders receive cash instead of stock. Under the aggressive view, the transaction then immediately goes from the least intensive form of judicial review to the most intensive.

Admittedly, there are some economic differences in the two transactions. Because the Zuckerman stockholders are receiving cash in the second transaction they would have to incur transaction costs to turn the money they receive into Angstrom shares. Nonetheless, they could readily do so if they wished.

But what is striking is how trivial this economic difference is compared to the great difference in the nature of the judicial standard that some practitioners would contend applies to each.\(^2\) In both situations, the Zuck-

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\(^3\) One learned commentator has noted that true mergers of equals are quite rare and in that in most friendly deals the “managers and directors of the target company will lose control over the future of the organization.” Coates, *supra* note 1, at 858-59 & n.107.

\(^2\) To complicate things further, suppose that the transaction was structured to afford Zuckerman stockholders a choice of cash or stock? How would that affect the applicable standard of review? *See In re Lukens Inc. Shareholders Litig.*, 757 A.2d 720, 725, 732 n.25.
erman stockholders arguably face their last real chance to get full value for the company, yet the two transactions are viewed as radically different legal matters.

Changing the hypothetical in another way raises another problem with using the QVC change of control test as a short-cut to resolving hard cases. Assume that the Zuckerman and Angstrom boards have decided to treat each share of Zuckerman stock as equal in value to each share of Angstrom stock. Also accept that the relative economic value of Zuckerman and Angstrom is proportionate to their respective sales in the last two years. Suppose Zuckerman’s sales were twice as large as Angstrom’s because of Zuckerman’s exclusive publishing contract with Britney Spears for her memoir of her month spent on Temptation Island.\textsuperscript{33}

Under the QVC test, the transaction would not be a change of control of Zuckerman because the current Zuckerman stockholders would be able to share in any future control premium. In the real world, this theoretical reality would provide little solace to Zuckerman stockholders. They would rightly be worried about whether the current merger represented an unfair transfer of wealth from the Zuckerman stockholders to the Angstrom stockholders. That is, the fairness of the exchange ratio would be critical to the Zuckerman stockholders because it fixes their claim on the assets of the combined entity—and thus their share of any future control premium. Put differently, the merger will be their final opportunity to be afforded payment for their now exclusive ownership of Zuckerman.

Given the economic importance of the transaction to the Zuckerman stockholders, how would one persuade a Zuckerman stockholder that his directors should avoid Unocal scrutiny of the deal protection measures simply because the transaction falls outside the reach of Revlon?\textsuperscript{34} What is the empirical evidence that suggests that the justifications that underlie the Unocal standard of review do not apply when a board adopts defensive deal protection measures to protect a stock-for-stock merger? Is it really the case that the directors and managers are less likely to be acting to preserve their positions in a non-Revlon transaction?

Assume that in the Stock-For-Stock Merger, the Zuckerman management would all be retained in high level positions, that the Zuckerman CEO, Mr. Roth, would be in line to be the next CEO of Angstrom, and that two-thirds of the Zuckerman directors would receive seats on the Angstrom board. Is there less of a risk to stockholders in this scenario than

(Del. Ch. 1999) (where 62% of transactional consideration was cash and 38% was stock; Revlon applied).

33. The author prays that this reference is hopelessly obscure to anyone reading this piece after the year of its initial publication.

34. To the extent that practitioners argue that overly strict judicial scrutiny of deal protection measures may lead bidders to hold back their best offers in negotiating stock-for-stock merger agreements, see, e.g., Rowe, supra note 1, at 18, they concede that price is important in these transactions and not just in Revlon deals.
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in a cash transaction in which the Zuckerman management and directors have no role in the continuing enterprise but only receive the value inherent in their severance and option packages based on the transaction price they had negotiated.\(^{35}\)

From experience, can practitioners really look themselves in the mirror and tell themselves that the typical stock-for-stock merger does not raise the sorts of concerns that led to the creation of the *Unocal* standard? Is it not the case that issues relating to managerial and board positions frequently dominate the discussions? Is it unknown for directors to be willing to merge with anyone but “those bastards”? Aren’t there non-*Revlon* mergers that are entered into precisely so that the merger parties can avoid being swallowed up by bigger industry players?

When viewed in this manner, the questions I’ve posed might tend to suggest that the *QVC* change of control test is intrinsically unsound. That is not my intent. Rather, what they are intended to do is to illustrate the limited utility of the change of control test.

The purpose of that test seems to me to be important, but narrow. It creates substantial certainty about those situations in which corporate directors are deemed to have the singular duty to pursue the transaction that will yield the highest immediate value. Because the imposition of this unidimensional focus has been aptly said to put directors in “a radically altered state,”\(^{36}\) it makes a good deal of sense to define the circumstances under which that focus is required with some rigidity.

What becomes less justifiable is if the *QVC* change of control test is also used to determine whether deal protection measures should be reviewed under the *Unocal* doctrine or the business judgment rule. It is this use of the *QVC* test that produces the odd result that the manipulation of trifling differences in the economic form of a transaction can have a profound effect on how searching judicial review of the transaction’s deal protection measures can be. What is all the more puzzling about reliance upon the *QVC* test for this purpose is this theory’s lack of grounding in judicial precedent, a problem I turn to now.

35. In a case within the past year, *McMillan v. Intercargo Corp.* C.A. No. 16963, 2000 Del. Ch. LEXIS 70 (Del. Ch. Apr. 20, 2000) (Strine, V.C.), defendant directors argued to me the exact opposite. Because they had approved a cash sale that contemplated that none of the incumbent directors would maintain their positions after the merger, the directors argued that their decisions should be given more deference than if they had approved a stock-for-stock merger in which they had secured continued service for themselves. *But see Gilson & Kraakman, supra note 1,* at 54 (noting that transactions in which target management will have no continuing role pose the potential for other conflicts of interests between management and the stockholders).

HAS THE STANDARD OF REVIEW QUESTION ALREADY BEEN SETTLED BY TIME-WARNER?

Perhaps the decision most beloved by practitioners who advocate deferential review of deal protection measures is the Supreme Court’s opinion in *Time-Warner*.\(^3\) Without doubt, that opinion was a clear statement of the substantial deference that must be accorded to well-motivated directors of Delaware corporations, even when those directors decide to engage in a mega-merger that may have the consequence of denying the stockholders access to a lucrative cash offer.

But often lost in the opinion’s crescendo of dictum are at least two key aspects of the decision that are crucial to the current debate about deal protection measures.

Let’s start with an obvious, but often overlooked point: *Time-Warner* did not involve a stock-for-stock merger that was subject to mandatory approval by the Time stockholders under Delaware law. Nor did it involve an attack on the Time board’s use of its poison pill or a change of control transaction invoking *Revlon* duties. In analyzing the questions before it, therefore, the *Time-Warner* court did not have to deal with several difficult power allocation issues.

Most notably for today’s purpose, the *Time-Warner* court did not have to decide whether the deal protection measures the Time board agreed to impinged upon the Time stockholders’ co-equal statutory right to make a decision about the proposed merger. By law, the merger with Warner was one that could be entered into by the Time board acting unilaterally.\(^3\)

37. During my speech, I deviated from the prepared text slightly at this point to ask the rhetorical question: “Where is so-called ‘Time Culture’ in the recent Time-Warner/America Online merger?” Although I did so mostly for whatever mild comic relief the remark would provide, the question raises a serious issue of corporation law that others have noted.

In *Time-Warner*, the Time board made much of its desire to secure the continuance of Time Culture—the structure that supposedly guaranteed the editorial integrity of *Time Magazine*—allegedly because of its economic value. *Time-Warner*, 571 A.2d at 1143-49. As perceptive commentators have noted, however, the actual implementation of the Time-Warner combination gave far less weight in practice to Time Culture than the board had given it as a litigation matter. See Joel E. Friedlander, *Corporation and Kulturkampf: Time Culture as Illegal Fiction*, 29 U. CONN. L. REV. 31 (1996); Joel E. Friedlander, *The CEO as Paterfamilias: A Case Study*, Prepared Remarks for the Federalist Society, Fifth Annual Conference on Corporate Governance, Sept. 22, 2000, *reprinted in Directors and Boards Mag.* (forthcoming). In fact, most of the protections supposedly necessary to secure Time Culture never made it into the merger agreement itself. Id.

A mere eleven years later, it would be interesting to know what has happened to Time Culture. Is it an island of journalistic and literary integrity in a vast sea of less high-minded products? What is Time Culture’s economic importance to the overall Time-Warner/AOL entity, as opposed to Time Culture’s societal value?

38. The Time board had earlier structured the merger with Warner in a way that, by virtue of stock exchange rules but not statute, required a vote of the Time stockholders. In reaction to Paramount’s tender offer, the Time board restructured the transaction to eliminate the need for a stockholder vote. This decision was upheld under the *Unocal* standard as
merger agreement that requires the assent of stockholders is not the same as a business decision a board has the unilateral power to undertake. Because the stockholders must vote to approve the merger, there is obviously a limit to the deal protection measures the directors can place in the merger contract—a limit the Time-Warner court did not have to address.

As important for the current discussion is the fact that the Supreme Court also decided the question of what standard of review applied to the deal protection measures contained in both the original and the final Time-Warner merger agreement, stating as follows:

Plaintiffs argue that the use of a lock-up agreement, a no-shop clause, and so-called “dry-up” agreements prevented shareholders from obtaining a control premium in the immediate future and thus violated Revlon.

We agree with the Chancellor that such evidence is entirely insufficient to invoke Revlon duties; and we decline to extend Revlon’s application to corporate transactions simply because they might be construed as putting a corporation either “in play” or “up for sale.” The adoption of structural safety devises alone does not trigger Revlon. Rather, as the Chancellor stated, such devices are properly subject to a Unocal analysis.

The Supreme Court’s decision in this regard is consistent with other decisions of the Delaware courts that have applied the Unocal standard of review to any measure that, viewed objectively, has the intended purpose and natural effect of obstructing the consummation of an unsolicited takeover attempt.

reasonable. Because the Time board was not self-interested, was fully informed, and believed in good faith that it was taking the best approach for the stockholders, the Court of Chancery held that it was not inappropriate under Unocal for the board to recast its original merger agreement to avoid a legally optional stockholder vote. Time, 1989 WL 79880, at *27-*30. The Court of Chancery also held that the directors had no fiduciary duty to put off the implementation of a well-thought out pre-existing strategy in order to give the Time stockholders a chance to consider another deal that a well-informed board viewed as less worthy. Id. at *28-*30. These conclusions were affirmed. Time-Warner, 571 A.2d at 1152, 1154.

39. In our hypothetical merger agreement, for example, provided that Angstrom would receive a 50% termination fee if the Zuckerman stockholders voted no, very few of us would think that was permissible. By making the costs of voting no so extreme, the Zuckerman board has in effect usurped all of the power to approve the merger to itself, in derogation of the statutory allocation of powers. Put simply, the Zuckerman board cannot contract away its stockholders’ right to make an uncoerced decision. If Angstrom demands a high fee for the purpose of placing a toll on the Zuckerman stockholders’ right to vote no, one should expect the court to be quite suspicious of the Zuckerman board’s decision to give in to that demand.

40. Time-Warner, 571 A.2d at 1151 (citations omitted).

41. For example, the decisions in Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270 (Del. 1994) and In re Santa Fe Pac. Shareholder Corp. Litig., 669 A.2d 59 (Del. 1995) both appear to treat the defensive provisions of non-Revlon stock-for-stock merger agreements as subject to
Time-Warner is consistent with other precedent as to another key point: the application of the Unocal doctrine does not depend on what corporate strategy the board is protecting or whether the defensive measure was adopted before an actual takeover threat emerged.42 The Moran case held that the adoption of a defensive measure on a clear day to protect corporate inertia was subject to Unocal review.43 It would be paradoxical to hold that the adoption of a defensive measure to prevent the disruption of a particular strategy—a stock-for-stock merger—should be exempt from these established principles.44

Other cases, notably QVC itself, make plain that the Delaware Supreme Court has, to date, not thought that the fact that a defensive measure was adopted by a board as part of a negotiated contract with a third-party exempted the measure from Unocal scrutiny.45 And as a logical matter, the contention that a defensive measure was a proper contractual inducement is an argument that the board acted reasonably, not an argument that justifies a different level of judicial scrutiny.46

Despite the apparent clarity of the existing caselaw, there are strands of judicial thought that create what some hear as dissonance.47 Because the bottom-line judgment of a board of directors that the economic terms of

Unocal review. Gilbert v. El Paso Co., 575 A.2d 1131, 1144 (Del. 1990), holds that Unocal applies when any defensive measure is taken in response to a threat to corporate policy and effectiveness that is related to control.

42. See Varallo & Raju, supra note 1, at 1631 n.90 (describing this proposition as “well settled”).

43. Moran, 500 A.2d at 1354; see also In re Gaylord Container Corp. Shareholders Litig., 753 A.2d 462, 477-87 (Del. 2000).

44. There is language in case law that states that Unocal review only applies to “unilateral” defensive actions taken by a board. E.g., Williams v. Geier, 671 A.2d 1368 (Del. 1996). Because deal protections measures are negotiated parts of bilateral executory merger contracts, this language could be read as suggesting that they fall outside Unocal. A closer reading of the cases suggests that the “unilateral” question turns solely on whether the defensive measures were adopted without involvement by the stockholders. See Williams, 671 A.2d at 1377 (“A Unocal analysis should be used only when a board unilaterally (i.e., without stockholder approval) adopts defensive measures in reaction to a perceived threat.”).

45. QVC, 637 A.2d at 42 (holding that deal protection measures in stock-for-stock merger agreement were subject to Unocal review); In re Santa Fe Pac., 669 A.2d at 71.

46. See Lebovitch & Morrison, supra note 1.

47. The case of Brazen v. Bell Atlantic Corp., 659 A.2d 43 (1997), perhaps added to the confusion. In that case, the Delaware Supreme Court applied a liquidated damages analysis to review a merger termination fee that had been expressly identified in the merger agreement as a liquidated damages clause. In doing so, the Supreme Court rejected the view that the clause should be reviewed, as the Court of Chancery had found, under the business judgment rule. The Supreme Court noted that the “reasonableness test” it applied to the liquidated damages clause was “analogous to some of the heightened scrutiny process employed by our courts in other contexts.” Id. at 49. Indeed, it would be difficult to conceive of how a Brazen analysis of a termination fee could come out differently than a Unocal review. The absence of any discussion of the Unocal standard in the case, however, obviously generates litigable doubt about the standard of review applicable to termination fees as a general matter.
a merger are favorable is one that has traditionally been reviewed under the business judgment rule, statements to this effect in the caselaw can be read as extending such treatment to the deal protection measures that are contained in merger agreements. In a sense what has happened is that the judiciary’s disciplined effort to avoid deciding whether a transaction is a good or better deal through the application of the business judgment rule has unwittingly contributed to the thought that defensive measures imbedded in merger agreements are entitled to equally deferential treatment.

Likewise, the judiciary’s frequent validation of deal protection measures can be bootstrapped into an argument for lenient review. Many Delaware decisions have validated hefty termination fees, strong no-shops, stock option grants, matching rights, and other measures that give a first-in suitor a large advantage over potential rivals and fair compensation if it loses out in the end. Because Delaware courts have frequently sustained the use of contractual deal protections, they have come to be seen as standard, unremarkable, and therefore in some sense entitled to hands-off business judgment rule treatment. This leap in logic is understandable given the tendency of some cases, particularly Unitrin, to weave a single, but cumbersome, garment out of the business judgment and Unocal standards of review. Understandable, but hazardous.

48. E.g., McMillan v. Intercargo Corp., C.A. No. 16963, 2000 Del. Ch. LEXIS 70 (Apr. 20, 2000) (Strine, V.C.); In re Lukens Inc. Shareholders Litig., Cons. C.A. No. 16102, 1999 Del. Ch. LEXIS 233 (Del. Ch. Dec. 1, 1999) (Lamb, V.C.); Crawford v. Cincinnati Bell, Inc. (In re IXC Communications Shareholders Litig.), Cons. C.A. No. 17324, 1999 Del. Ch. LEXIS 210 (Del. Ch. Oct. 27, 1999) (Steele, V.C.); Goodwin v. Live Entertainment, Inc., C.A. No. 15765, 1999 LEXIS 5 (Del. Ch. Jan. 22, 1999) (Strine, V.C.); Matador Capital Management Corp. v. BRC Holdings, 729 A.2d 280 (Del. Ch. 1998); see also Volk et al., supra note 7, at 1117. (“Generally speaking, a break-up fee of approximately 1%-3% of the aggregate transaction value (with the lower range of percentages in large transactions and the higher range in small transaction) is likely to be deemed reasonable if it results from arm’s length bargaining and is not supplemented by a lock-up option. In transactions that do not implicate Revlon duties, larger amounts should be permitted as a means of defending the transaction from interference if they fall within a range of reasonableness for that purpose.”);

49. I concede that some recent opinions appear to hold that deal protection measures adopted in advance of another bidder emerging are to be reviewed under the business judgment rule rather than Unocal, regardless of the objectively defensive nature of the deal protections. See State of Wis. Inv. Bd. v. Bartlett, C.A. No. 17727, 2000 WL 238026 (Del. Ch. Feb. 24, 2000) (Steele, V.C.); In re IXC Communications, 1999 WL 1009174. A close reading of the cases indicates that the court nonetheless carefully reviewed the process by which the boards decided to adopt the provisions under attack. See Varallo & Raju, supra note 1, at 1613 (“As a general rule, Delaware courts have upheld termination fees that do not exceed 2-3½% of the value of the transaction. Where a termination fee begins to exceed 3-4% of the transaction value and/or if the termination fee is significantly larger than the actual costs incurred, the possibility is raised that the termination fee will be viewed as a device motivated to preclude bona fide third parties from coming forward.”).


WHAT DOES QUICKTURN SUGGEST ABOUT THE LEVEL OF JUDICIAL SCRUTINY THAT WILL BE APPLIED TO DEAL PROTECTION MEASURES THAT DISABLE A BOARD FROM ACCEPTING OTHER OFFERS?

To see why, one only has to look at a decision like Quickturn, which appears, at first blush, to have a strikingly different tone and emphasis than Time-Warner.

In Quickturn, Mentor made a bid for Quickturn. The Quickturn board was not in Revlon mode, it simply faced an offer at fifty percent over its then-current market price. The Quickturn board adopted a slow-hand pill that was unredeemable for six months by a newly elected board.

The Supreme Court found that the slow hand pill was invalid as a matter of statutory law because it “impermissibly deprive[d] any newly elected board of both its statutory authority to manage the corporation under 8 Del. C. § 141(a) and its concomitant fiduciary duty pursuant to that statutory mandate.”

The Court’s analysis of the slow hand’s validity began with a consideration of Moran. The Quickturn court stressed that Moran’s holding that a board could validly adopt a pill under section 141(a) was conditional on the understanding that the board’s decision to keep the pill in place would be subject to later Unocal review.

The Court then emphasized that “[o]ne of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation.”

The Court noted that the slow hand pill “would prevent a newly elected board of directors from completely discharging its fundamental management duties to the corporation and its stockholders for six months.” Although this limitation was only on the board’s power to accept a tender offer, “it nonetheless restricts the board’s power in an area of fundamental importance to the shareholders—negotiating a possible sale of the corporation. Therefore, we hold [that the slow hand pill] is invalid under Section 141(a), which confers upon any newly elected board of directors full power to manage and direct the business and affairs of a Delaware corporation.”

2000) (discussing the awkward relationship between the Unocal standard and the business judgment rule).

53. Id. at 1288. Rights plans of this type are also called delayed redemption pills or “no-hand” pills.
54. Id. at 1291.
55. See id. (citing Moran, 500 A.2d at 1354).
56. Id.
57. Id.
58. Id. at 1291-92.
The Court then refers to the fiduciary duties of directors as "unremitting," as extending to contests for corporate control, and notes that such duties must be exercised in the light of changing circumstances. It then quotes QVC as follows: "'[t]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.'" The slow hand pill was invalid because it would require the "new [Quickturn] board to breach its fiduciary duty" by prohibiting that board from redeeming the pill even if the directors believed a good offer was on the table.

*Quickturn* can be read as articulating a fundamental corollary to the authority invested in directors to manage their corporation's participation in the M&A marketplace: the directors must be cautious not to abdicate that responsibility and leave the corporation rudderless. Put another way, the directors cannot arrogate to themselves the authority to determine when their stockholders may receive a tender offer, and then disable themselves from exercising that same authority.

If *Quickturn* can be thought to stand for this general proposition, it has implications for the validity of certain deal protection measures. Another variation on our basic hypothetical illustrates what I mean.

Let's start with a simplified version of the basic facts of *Quickturn*. Assume the Zuckerman board decides in good faith that the corporation's standalone business plan is just plain terrific. It does not want management's implementation of that plan to be distracted by takeover threats. Moreover, it makes the judgment that any new Zuckerman board ought to get a real feel of the place before it decides otherwise. Hence, the incumbent board adopts an Eric Clapton pill to prevent a newly elected board from redeeming the pill for forty-five days after taking office. The reasoning of the actual *Quickturn* opinion is clear: the Zuckerman board cannot do this as a matter of statute or fiduciary duty.

Now let's change the scenario into one involving deal protection measures. Assume that the Zuckerman board had instead decided to enter into the Stock-For-Stock Merger Agreement with Angstrom, believing in good faith in the soundness of that transaction. Posit, however, that the merger agreement will not terminate for a full eighteen months and that no vote is to be scheduled for at least a year. During that period, the Zuckerman board agrees that it will not talk to any other bidder, that it will recommend the deal and put the transaction to the Zuckerman stockholders regardless

59. *Id.* at 1292.

60. *Id.* (quoting Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 51 (Del. 1994) (emphasis added by the *Quickturn* court)).

61. *Id.*

62. As commentators favoring more deferential review of deal protection measures admit, the *Time-Warner* case involved a Time board that had preserved the right to explore other options but made an informed decision not to do so. *See Rowe, supra* note 1, at 8, n.11.
of changed circumstances, and that Zuckerman will pay a 7.5% termination fee if the deal does not transpire. And, Zuckerman, as you recall, has a pill in place and its directors’ decision to redeem the pill for another offer would breach the Merger Agreement and trigger the termination fee.

As I think is obvious, the deal protection measures in this hypothetical may in fact leave the Zuckerman board with far less flexibility than even the forty-five day slow-hand pill. For a period of eighteen months, the deal protection measures render the Zuckerman board helpless to allow the Zuckerman stockholders access to a favorable tender offer without exposing Zuckerman as an entity (and thus any potential purchaser) to the potential liability for the 7.5% termination fee and even higher contract damages. Fiduciaries who had already seized the authority to prevent their stockholders from freely receiving tender offers (through the pill) have then made a unilateral decision (through the adoption of the deal protection measures) that casts the enterprise adrift for eighteen months in a highly dynamic marketplace.

While one can overstate the similarities between these two scenarios, I leave you to consider for yourself the following question: Should board decisions that produce strikingly similar results be subject to different levels of judicial scrutiny?

**THE EX ANTE VERSUS EX POST PROBLEM**

One of the most prevalent fetishes in corporation law is the adoration lawyers and law professors have with the words “ex ante” and “ex post.” I raise this linguistic issue not to play Safire or Kingsley Amis, but to hit on a point often raised by those who fear heightened judicial scrutiny of board decisions. The concern they harbor is that courts (perhaps subconsciously) do not assess a board decision to agree to deal protection measures based on the information the board possessed at that time, but in view of later developments—such as a topping bid. Because it is always easier to make a correct decision with the benefit of hindsight, there is a danger that judges will substitute their judgment for that of directors too easily.64 If this is done on a persistent basis and the decisions of well-motivated di-

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63. Assume that the Merger Agreement prohibited Zuckerman from consummating another merger during an eighteen-month period. Theoretically, Angstrom could seek specific performance of Zuckerman’s obligation not to do another deal until the Merger Agreement expired. The enforceability of such promises is well considered in Regan, supra note 1.

64. See Allen, supra note 1, at 657 (“[C]ourts are directed in these change in control cases to engage in some post hoc “reasonableness” review of acquisition agreement terms that might impair the ability of a corporation to seize a later, better proposal. Obviously, when a court does so it will necessarily act through fallible human beings. Courts can, on any level, get things wrong. In such a world, it is to be expected that active, skeptical judicial review of a merger agreement’s deal protective terms, after the fact that another higher deal has emerged, may read such provisions as a sign of bias or carelessness . . . . a fair interpretation of QVC Network. Naturally, such an interpretation may sometimes be incorrectly made.”).
rectors to grant deal protections cannot be relied upon by merger partners, there may be a diminution in value-maximizing transactions, to the overall detriment of stockholders. This is a legitimate concern, and one that builds on the corporation law’s recognition that the judiciary is ill-suited to determine whether a proper judgment call was made by a board about a business matter.

One manner of addressing these dangers is through categorization. If deal protection measures in non-Revlon deals are subjected to deferential business judgment treatment, there is upfront clarity that allows transactions to proceed with little risk of judicial disruption. While this may allow some sub-optimal transactions to be approved, in the aggregate it is hoped that this approach will produce more value-creating transactions than would be the case if the judiciary were afforded greater leeway to issue injunctions.

Such an approach, however, has its own dangers. Appropriately applied, heightened scrutiny can check abuses and encourage board behavior designed to protect stockholders. That is, both the threat of ex post judicial intervention and the lessons articulated in case law may serve to enhance the quality of director decisionmaking about strategic mergers ex ante. These values could be lost if the more flexible Unocal standard cannot be applied.

Even worse, the business judgment rule itself might become distorted if used for this purpose. Because of the importance of merger transactions and their profound effect on management’s future, deal protection measures that protect management’s favored deal tend to give a stock-for-stock merger agreement the flavor of an interested transaction. If courts are required to use the business judgment rule to examine deal protection measures, they may be tempted to stretch the traditional applications of that test in order to justify entire fairness review. As a result, there is a danger that heightened scrutiny may re-emerge in another less candid guise, thereby undermining the certainty business judgment review was supposed to create, not only in the M&A context, but in other areas of corporation law. Another similar danger is that the QVC change of control test will be loosened to slip more deals under the Revlon rubric.

In the end, practitioners looking for reasonable certainty might do better under a regime that requires courts to apply the Unocal standard to deal protection measures but with a mindset that: (i) looks to validate well-motivated and well-informed board decisions, and (ii) accords due respect to the legitimate contractual rights of merger partners. This approach also has the advantages of being transparent and in keeping with the obvious defensive nature of deal protection measures.

65. See, e.g., Rowe, supra note 1, at 18–19; Allen, supra note 1, at 655.


Under a “duck” approach to the law, “deal protection” terms self-evidently designed to deter and make more expensive alternative transactions would be considered defen-
Moreover, the argument that heightened judicial review of deal protection measures is unduly infected by hindsight bias does not seem terribly substantial. Many judicial decisions give enormous weight to the record a board of directors made ex ante—i.e., in advance of agreeing to deal protection measures. These decisions make clear that a well-informed board may give a significant and enforceable bidding advantage to its preferred merger partner in a non-Revlon stock-for-stock merger agreement. These rulings give boards credit for the attention they gave to the deal they were developing, their consideration (through a variety of means) of alternatives, and the care with which they negotiated the deal protections. That is, the ex post judicial review of the directors’ decision to agree to the measures is largely based on the record the directors made ex ante.

But it is natural that the court will look for a record of deliberations commensurate with what is at stake. If lock-ups are extraordinary, did the board know about that? What was the reason for agreeing to them? Was the deal that good? How confident was the board that another more favorable transaction would not arise, including a substantial topping bid or a better strategic merger? Did the board negotiate

sive and reviewed under the Unocal Corp. v. Mesa Petroleum Co., Del. Supr., 493 A.2d 946 (1985) standard. The word “protect” bears a close relationship to the word “from.” Provisions of this obviously defensive nature (e.g., no-shops, no-talks, termination fees triggered by the consummation of an alternative transaction, and stock options with the primary purpose of destroying pooling treatment for other bidders) primarily “protect” the deal and the parties thereto from the possibility that a rival transaction will displace the deal. Such deal protection provisions accomplish this purpose by making it more difficult and more expensive to consummate a competing transaction and by providing compensation to the odd company out if such an alternative deal nonetheless occurs. Of course, the mere fact that the court calls a “duck” a “duck” does not mean that such defensive provisions will not be upheld so long as they are not draconian.

67. Even when Revlon duties have been invoked, the Delaware courts have been careful to permit boards to use a variety of different methods to ensure that they attain the best deal reasonably available. For the most recent Delaware Supreme Court statement to this effect, see McMullin v. Beran, 765 A.2d 910, 919-20 (2000). For a more recent application of this flexibility in operation, see In re Pennaco, Inc. Shareholders Litigation, C.A. No. 18606, 2001 Del. Ch. LEXIS 19 (Feb. 5, 2001) (Strine, V.C.) (where board focused on simple bidder but negotiated modest deal protections that afforded the opportunity for an adequate market check, a Revlon claim failed to sustain preliminary injunction application).

68. In giving a speech, one attempts to use language in a clear, flowing fashion. By this short-hand reference, I simply note that the board’s own knowledge and belief about the economic attractiveness of its favored deal is a relevant consideration in considering the reasonableness of the deal protections it embraced. By noting this uncontroversial feature of a fiduciary conduct analysis, I do not imply that the court is to choose the best deal or apply an oxymoronic judicial “business judgment” to the economic questions faced by the board and the stockholders.

69. The incidence of recent situations in which boards later concluded that their original agreement was not as favorable as a later-emerging transaction is not trivial. See Robert E. Spatt, The Four Ring Circus—Round Five; A Further Updated View of the Mating Dance Among Announced Merger Partners and an Unsolicited Second or Third Bidder (Feb. 6, 2001) (unpublished manuscript).
as hard as possible to minimize the restrictions on its own flexibility?\(^{70}\)

If the board did not consider any of these issues \textit{ex ante} it seems to me to be \textit{ex post} carping for its advisors to complain if a court views the board’s actions with a gimlet eye.

\textbf{DOES A JUDICIAL EMPHASIS ON UNCOERCED STOCKHOLDER VOTES RECONCILE THE COMPETING VALUES IMPLICATED BY DEAL PROTECTION MEASURES IN STOCK-FOR-STOCK MERGER AGREEMENTS?}

Where does this whirlwind of decisional law leave us? How does one reconcile \textit{Time-Warner’s} emphasis on the directors' authority to chart a course for the enterprise with \textit{Quickturn’s} requirement that the directors retain the flexibility to consider an unsolicited bid? In what manner can the law acknowledge that merger transactions fall along an economic continuum while also confining the situations when directors are rendered faithful salesmen by the \textit{Revlon} standard? Should we allow some suboptimal and even badly-motivated deals to slip through rather than risk the overall reduction in good transactions that heightened judicial involvement might produce? How do we balance the interests of stockholders in making a free choice on a stock-for-stock merger with the contract rights of the merger partner who would be harmed by a no vote?\(^{71}\)

Take heart. As a closing point, allow me to suggest that there may be a practical way to reconcile these arguably competing policy values. Although one can press the point too far, an approach that focuses on uncoerced stockholder choice does much to reconcile these values.\(^{72}\) How?

\(^{70}\). For a thought-provoking article arguing that the review of deal protection measures should focus on the quality of the board’s decisionmaking process, see Varallo & Raju, \textit{supra} note 1, passim.

\(^{71}\). One possible way in which courts could strike this balance would be to issue injunctive remedies that are narrowly tailored to redress only the harmful effects of directorial overreaching as manifested in deal protection measures. That is, to the extent possible the court should not strip a merger partner of all of its contractual deal protections because those protections are unenforceable to their fullest written extent. Instead, the court should endeavor to pare away only the forbidden excess, leaving the merger partner with the benefits of those protections that fall within recognized standards of acceptability. \textit{Cf.} Regan, \textit{supra} note 1, at 25-28 (discussing the fact that contract provisions that are invalid because they are in violation of fiduciary principles may not be specifically enforceable, but may still give rise to other less extreme remedies). Although this paring exercise may be imprecise, it involves far less judicial intrusion than does the flat-out invalidation of, for example, all of an excessively high termination fee. \textit{Cf.} Allen, \textit{supra} note 1, 659 (suggesting that courts must be careful to acknowledge that the fact that a merger contract may not be subject to specific performance in all respects does not mean that it is not a source of any enforceable rights).

\(^{72}\). I do not claim this insight or perspective to be a novel one. For a similar perspective, see, e.g., Gilson & Kraakman, \textit{supra} note 1, at 56 (arguing that so long as stockholders have a freedom of choice, even in the \textit{Revlon} framework that management should be permitted to
For starters, this emphasis is faithful to a key theme of Time-Warner. Well-motivated directors ought to have the right to present a strategic merger to their stockholders and to give their merger partner substantial contractual protections to induce them to contract. Unlike in the Revlon context, the court will defer to director decisions to give a preferred merger partner bidding and timing advantages over later emerging rivals. This deference to directors, as a practical matter, may mean that the courts will give scant weight to whether deal protection measures are preclusive of other bids as a short-term matter.\(^{73}\) That is, if all that the board is asking for is to go first and to require other bidders to await the outcome of an unfettered stockholder vote, it seems likely to get that opportunity.

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

This judicial emphasis on stockholder choice makes sense. It gives boards the first bite at the apple and contractual tools to use to accomplish their preferred strategy. It enables the merger partners to receive contractual protections that limit their injuries if transactions do not go through. But it also ensures integrity by limiting the boards’ ability to intrude on the stockholders’ co-equal right to approve mergers.

Of course, the judicial task of determining whether deal protection measures have deprived the stockholders of a fair chance to vote freely on a transaction has its own difficulties. Nonetheless, channeling the judicial inquiry in this way has the virtue of reinforcing the primacy of director and stockholder decisionmaking. It also provides a relatively elegant way of acknowledging the greater scope of director discretion that exists in the non-Revlon context, while also recognizing that the stockholder “ownership” interests that take primacy in the Revlon context also loom large when a corporate board presents a stock-for-stock merger agreement.

\(^{73}\) This statement recognizes that long-term preclusion may result in immediate coercion at the ballot box.