The *Delaware Journal of Corporate Law*
of Widener University Delaware Law School

presents the

33rd Annual Francis G. Pileggi Distinguished Lecture in Law

Is Delaware Retreating?

Randall S. Thomas

John S. Beasley II Chair in Law and Business

Director, Law & Business Program

Professor of Management, Owen Graduate School of Management

Vanderbilt Law School

Friday, October 20, 2017

8:00 a.m. Breakfast; 8:45 a.m. Lecture

Hotel DuPont, du Barry Room
11th and Market Streets
Wilmington, Delaware 19801

Encore presentation 11 a.m.
Widener University Delaware Law School

Widener University 1821
Delaware Law School

delawarelaw.widener.edu

Delaware's Retreat: Exploring Developing Fissures and Tectonic Shifts in Delaware Corporate Law

By James D. Cox, Duke Law School &
Randall S. Thomas, Vanderbilt Law School
October 20, 2017

Key Corporate Law Cases That Changed Judicial Review of Board Decisions

- We focus on four critical decisions from the 1980's that changed the scope of judicial review by Delaware courts:
- Revlon – sale of control
- Weinberger – minority shareholder squeezeouts
- Unocal – defensive tactics
- Blasius – shareholder voting

How Have Those Cases Evolved Over Time?

- Within the space covered by each doctrine, Delaware has reduced judicial scrutiny of board actions
- Instead, Delaware law has shifted toward giving more deference to independent boards' decisions (Unocal), more use of process-oriented devices and greater deference to after the fact shareholder approval of board actions (Revlon and Weinberger), and greater reluctance to intervene in manager-shareholder arguments over the boundaries of their power (Blasius)

Why Have These Changes Occurred?

- We argue that there have been significant corporate governance shifts since the 1980's that have led to these shifts
- These changes include:
- Growing use of independent directors – they are invariably a majority of the board of directors now
- Increased concentration of institutional shareholdings and the rise of ISS – large investors are more assertive about getting what they want
- Hedge fund activism – since early 2000s, activist hedge funds have been aggressively targeting underperforming companies and frequently have succeeded in forcing changes at them
- Recent explosion in deal litigation – up to 96% of larger deals attract shareholder litigation in 2013

Are These Changes a Good Thing?

- Some commentators have applauded them, claiming that private enforcement efforts have run amok and arguing independent directors, shareholder voting and procedural protections provide ample protection
- Other commentators have criticized them, pointing out that shareholder monitoring of corporate management will be weakened, increasing the potential for an increased incidence of corporate misconduct

Revlon – The Beginning

- Perelman makes hostile bid, Revlon deploys defenses, but Perelman persists in his efforts to takeover the company
- Board determines to sell the company to Forstmann Little; ultimately offers them substantial preferences to make a second bid
- Directors' role changed to being "auctioneers" once they determined to sell the company – must seek best deal
- Court engages in close judicial scrutiny of preferential treatment of one bidder over another in a sale of the company
- Two bidder situation with strong scent of self dealing in the case

Paramount/QVC – Clarifying Revlon

- Friendly deal between Paramount and Viacom that has strong deal protections is disrupted by QVC's announcement of a competing bid
- Viacom and QVC get into a bidding contest but presence of deal protections interferes with P board's consideration of QVC offer
- Court concludes that the initial friendly deal constituted a change of control transaction triggering Revlon because it would create a controlling shareholder in the newly merged entity
- Court strikes down deal protections as breach of director duties
- In a two bidder setting, the directors' actions in preferring one bidder over another are carefully scrutinized against the best offer criterion

Lyondell and One Bidder Cases

- Lyondell involves a single bidder that makes a strong bid to buy the company and a board that accepts it without doing much negotiating in a short period of time
- Court says Revlon did not create any new director fiduciary duties – just duty of care and duty of loyalty
- Duty of care claims are difficult in one bidder cases because 102(b)(7) eliminates post-closing money damage claims – no injunction is likely to be possible in one bidder cases
- Lyondell makes duty of loyalty claims problematic too by saying that independent directors must "utterly fail to attempt to obtain the best price" to be found to have breached the duty of loyalty

Corwin– Revlon's Closing Act?

- A one bidder, stock for stock merger deal that the Delaware Supreme Court treated as if it had triggered Revlon
- Court holds that in an arm's length M&A transaction involving a sale of control under Revlon a fully informed, non-coerced, disinterested shareholder vote approving the deal invokes the business judgment standard of review
- Court effectively overrules earlier precedent requiring separate votes for this purpose-- one vote approving the merger and a second vote ratifying the directors' actions in conducting the transaction

Corwin's Implications and Justifications

- On the positive side, in single bidder cases, using shareholder voting to replace judicial review will lead to less litigation and its associated costs
- But if shareholder approval absolves the board from any liability under Revlon, will we see boards abandoning auctions and market checks as unnecessary parts of their sale process?
- More importantly, bundling the merger approval vote with the merger ratification vote into a single vote confronts shareholders with a distorted choice – if they vote in favor of a deal where there is clear board impropriety, what does that vote mean?
- Unbundling the vote on the two items would allow shareholders to send a clear message about both things

Weinberger and Entire Fairness Review

- Control shareholder (CS) squeezeout where two interlocking directors did a valuation of target firm using target private information and gave it to the CS acquirer's board but not the target's board
- Target board did almost no negotiating then concluded the deal on a hasty basis without any pressing reason
- Court applies entire fairness standard and finds CS breached its duties to the minority shareholders; remands for damage determination
- In footnote, Court exhorts future deals to use special committee to shift burden of proof in entire fairness test onto plaintiff
- Court also notes that MOM vote would have similar effect

Kahn v. Lynch: The Rise of the Special Committee

- Delaware Supreme Court clarifies that a special committee in a CS squeezeout must have "real bargaining power" for a shift in the burden of proof onto the plaintiff in entire fairness analysis
- The CS negotiated with the Special Committee but when an impasse was reached, the CS threatened to move forward with a tender offer at a lower price, leading the Court to deny the burden shift
- Court states that entire fairness analysis remains the proper standard for judicial review even if Special Committee or MOM vote is used because existence of control shareholder is inherently coercive
- Does not decide the effect of Special Committee and MOM vote

M&F Worldwide – Using Procedural Protections to Eliminate Entire Fairness Analysis

- CS makes a proposal to take a company private contingent on approval by an "empowered" independent special committee and an uncoerced, fully informed, MOM vote
- Court concludes that the combination of those two procedural devices was equivalent to approval of a fully independent board and an uncoerced shareholder vote in an arm's length transaction, and therefore applies business judgment review of the deal
- Court rejects plaintiffs' arguments that special committee is a weak negotiator because it is comprised of directors selected by the CS and that minority vote suffers from inherent coercion from presence of CS

Effects of M&F Worldwide (and Corwin)

- Move to substitute procedural protections and shareholder vote for judicial oversight will undoubtedly reduce risk of litigation
- Making it harder for shareholders to successfully challenge deals in Delaware has the predictable effect that deal litigation will migrate to other venues, such as federal court
- Within Delaware, also predictable that shareholders will seek to pursue alternative remedies, which may account partly for the upsurge in appraisal cases
- Further, CS incentives to pay high price for minority interests are reduced if monitoring role of litigation is weakened

Unocal - Heightened Judicial Review of Defensive Tactics

- Prior to 1985, Delaware courts generally applied business judgment review for target defensive actions
- T Boone Pickens makes a two tiered, front end loaded, coercive tender offer to buy Unocal Corporation
- Board determines that the offer is coercive and inadequate and adopts a discriminatory self tender offer as a defensive tactic
- Delaware Supreme Court holds that due to the "omnipresent specter" of board entrenchment when deploying defensive measures it will apply enhanced judicial scrutiny to Unocal board action and adopts new two part test for these situations

Interco– The Path Not Taken

- Three years later, Rales brothers make an all cash, all shares, hostile bid for Interco, seeking to bust up the company and sell the parts
- Target board responds by adopting a new poison pill and announcing a massive restructuring of the company that would have much the same effect as the Rales' bust up proposal
- Chancellor Allen determines that the offer is not coercive and that the poison pill could be kept in place while management sought to negotiate a higher price, or propose an alternative transaction, but that after that period had elapsed, the poison pill should be redeemed to allow shareholders to choose between the tender offer and the management restructuring option

Time/Warner – Threat Prong of Unocal

- Not long after Interco, Time and Warner sought to enter into a stock for stock merger deal, only at the last minute to find that Paramount made a higher priced tender offer for Time
- Time responded by refashioning the initial transaction as a cash tender offer to acquire 51% of Warner to be followed by a second step merger
- Delaware Supreme Court overruled Interco's threat analysis
- It further modified the first step of the Unocal test, by greatly expanding the list of potential threats posed by a hostile tender offer that could be considered by a target's board of directors
- Case marks the end of meaningful judicial review of the threats posed by a hostile offer, giving great deference to the board's determination of them

Unitrin – Reasonableness Prong of Unocal

- American General announced a cash tender offer for all of Unitrin's stock so Unitrin's board (which held 23% of the stock) announced a stock repurchase that would raise the directors' holdings to 28%
- Unitrin's articles of incorporation required a 75% vote for any merger so that the effect of the stock buyback was to give Unitrin's directors an absolute veto over any merger
- Delaware Supreme Court revises the reasonableness prong of Unocal to limit it to barring "preclusive" and "coercive" defenses with all other defenses measured under a less stringent "range of reasonableness" standard

Airgas– The Costs/Benefits of Unocal Today

- The net effect of Time/Warner and Unitrin was to severely limit judicial review of poison pills and other common defense tactics, alone or in combination, and perhaps not surprisingly there were relatively few hostile tender offers thereafter
- Chancellor Chandler's Airgas decision illustrates the difficulty that hostile acquirers face as it holds the combination of the poison pill and classified board is not preclusive, despite the fact that no bidder has ever successfully overcome it
- After Airgas, as the Chancellor notes, "the limits of the poison pill remain to be seen."

Blasius – Protecting Shareholder Franchise

- A substantial stockholder of Atlas Corporation initiated a written consent solicitation seeking to expand Atlas board and fill the resulting vacancies with its own candidates to gain control of the company
- The Atlas directors acted immediately to fill two board vacancies to block a change of control of its board in a good faith belief that this was necessary to protect the company from harm
- Chancellor Allen struck down the board's action, finding that it acted with a primary purpose of intruding on shareholder voting rights, and thereby interfered with the allocation of power between the principals (shareholders) and their agents (directors) and that when doing so a board must show a "compelling justification" for such an action

Delaware Courts Cut Back Blasius

- In a series of post-Blasius cases, the Delaware courts cut back sharply on its scope and meaning
- One major shift was to clarify that Blasius would not be invoked in situations where the board's action only incidentally affected shareholder voting rights (Stahl v. Apple Bancorp)
- Delaware Supreme Court holds that Blasius does not apply if there is a fully informed shareholder vote (Stroud v. Grace)
- Another restriction was the Delaware Supreme Court's decision to incorporate Blasius into the Unocal test in cases involving unilateral board defensive action (Grace v. Stroud; Williams v. Geier)

Eliminating Blasius?

- Chancellor Allen has argued in a 2001 article that the Blasius inquiry is just an extension of the reasonableness inquiry in Unocal/Unitrin so that there is no need for layering onto that standard a demanding "compelling justification" showing
- Then Vice Chancellor Strine (who coauthored the 2001 article just mentioned) took a similar approach in Chesapeake v. Shore
- Finally, the Delaware courts have not separately evaluated advance notice bylaws, which directly affect voting, under the Blasius standard and have instead preferred Unocal or the inequitable purpose doctrine

What Explains the Shift in Revlon?

- The deal litigation explosion resulting from the plaintiff friendly standard in Revlon led to a widespread perception that private enforcement of director fiduciary duties was out of control
- This supported Delaware's approval of the creation of forum selection bylaws, thereby channeling deal litigation to the Delaware courts
- The widespread use of disclosure only settlements led to the Chancery Court's decision In re Trulia, which had the effect of restricting settlements
- On top of that, Revlon was increasingly viewed as a poor fit for single bidder cases while two bidder cases are rare
- Finally, the Corwin decision indicates Delaware courts' deference to the sophisticated shareholder vote and faith that low priced deals will attract higher bids in efficient securities markets

Why The Changes in Weinberger?

- Many of the same forces as with Revlon, such as the explosion of deal litigation
- In particular, the entire fairness standard gives plaintiffs strong settlement leverage even in the weakest cases because of the difficulty in getting these cases dismissed on the pleadings
- M-F Worldwide shows deference to the use of independent directors and informed institutional investors
- M-F Worldwide completes the mosaic of changes to this legal standard for self-dealing transactions

Unocal – Why Did We Wind Up Here?

- Unocal's importance has dwindled with the decline of hostile deals – in part because of the difficulty in overcoming defenses such as the poison pill, but also because of the increased use of pay for performance and golden parachutes for senior management and directors have given them strong incentives to do more deals
- The decisions also illustrate great deference to informed shareholder voting decisions as the proxy contest remains the only viable avenue for overcoming the poison pill
- Hedge fund activism and its focus on short slate contests and aggressive board representation have supplanted hostile takeovers as the principal monitoring device for shareholders

Blasius Today

- Despite its strong theoretical appeal, the decision has been confined to a small slice of cases and is under assault even there
- The Delaware courts have cabined it into that tiny space because to have fully recognized the doctrine would have had great impact on board – shareholder relationship
- Example: Poison pill – Stahl v. Apple Bancorp is a good illustration – what would have happened if the Apple board had needed to show a compelling justification for the negative impact that the flip-in pill has on shareholders' ability to buy stock, nominate directors and share the costs of a proxy contest?

Our Bottom Line

- We acknowledge the weakening of shareholder oversight that invariably accompanies reductions in private enforcement efforts, but also recognize the legitimate reasons that prompted that change
- We argue that shareholder monitoring can occur in many ways, that corporate governance changes have improved investor monitoring significantly, and that hedge fund activism is particularly important in meeting that need
- Overall, we conclude that Delaware is on the right track but we would want to revisit that conclusion if Delaware takes strong action to curtail hedge fund activism