Revisiting *Revlon*: Should Judicial Scrutiny of Mergers Depend on the Method of Payment?

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INTRODUCTION

Suppose that one corporation, BuyCo, wants to purchase another, TargetCo. If BuyCo uses cash to purchase TargetCo, Delaware courts will apply enhanced scrutiny to the deal, forcing TargetCo's directors to show that they acted reasonably in pursuit of the highest value reasonably available for the company.[1] If BuyCo uses its own stock to purchase TargetCo—assuming that both corporations are widely held—courts will apply the deferential business judgment rule to the acquisition.[2] But what happens if BuyCo uses a mix of cash and stock in the deal? For corporations contemplating such an acquisition, the level of judicial scrutiny is uncertain.

This Comment tracks the development of a new approach in Delaware law that ignores the method of payment in these situations. The fundamental concern underlying the application of enhanced scrutiny to the actions of target directors who negotiate takeover deals is that they are effectively negotiating away their jobs. This exacerbates agency costs. The concept is intuitive: Imagine that you own a company whose continued existence depends on signing up a big new client. Do you send out the salesman who just put in his two weeks' notice?

The new approach highlights this commonsense intuition about human behavior. Cash and stock are both currency. The choice of which to use has little to do with the agency costs that justify enhanced scrutiny. Method of payment is not a proxy for structural bias.

One benefit of a unifying approach is to remove the confusion presently created by mixed-consideration transactions. Current doctrine treats cash acquisitions and stock acquisitions as fundamentally different from one another. Yet, mixed-consideration acquisitions show that the two currencies serve precisely the same function:

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1 See *Paramount Communications Inc v QVC Network Inc*, 637 A2d 34, 45 (Del 1994).

2 See id at 45 n 17.

giving stockholders value in exchange for their equity stake in the target corporation.

Two recent Delaware Chancery Court decisions, *Steinhardt v Occam Networks, Inc*[3] and *In re Smurfit-Stone Container Corp Shareholder Litigation*,[4] hold that enhanced scrutiny should apply to acquisitions evenly split between stock and cash.[5] In doing so, they present a new model for determining when enhanced scrutiny applies to corporate takeovers: the final-stage transaction theory.[6] This theory identifies three motives for heightened judicial scrutiny in the takeover context. First, the "omnipresent specter" of structural bias—a suspicion that directors about to lose their jobs might inadvertently allow their own interests to take precedence over those of shareholders.[7] Second, the "no tomorrow" issue—a takeover is the last chance for a shareholder to have her fiduciary maximize a particular investment.[8] Whether she receives cash or stock in exchange for her shares, the investment is fundamentally transformed. Third, the "last-period" problem—the concern that market and reputational incentives will not restrain target directors and officers in their last period of employment. Taken together, these issues point to a much broader application of enhanced scrutiny than is required by the current change of control test.

With that in mind, this Comment proposes applying the enhanced scrutiny doctrine, established in *Revlon, Inc v MacAndrews & Forbes Holdings, Inc*,[9] independently of the means by which an acquisition is funded. Broadly applying enhanced scrutiny has substantial advantages over the current approach. It unifies the legal doctrine applying *Revlon* with the core observation about agency costs that underlies that decision. The confusion regarding the status of mixed-consideration deals is also resolved; a bright-line rule applying enhanced scrutiny to all final-stage transactions lets directors know where they stand at all times. Moreover, *Revlon* enhanced scrutiny has evolved into a nuanced standard well suited to identifying and deterring the subtle conflicts implicated by the concerns presented above. To accomplish this doctrinal expansion, this Comment

3 No 5878–VCL, transcript op (Del Ch Jan 24, 2011).

4 2011 WL 2028076 (Del Ch).

5 *Steinhardt*, No 5878–VCL, transcript op at *85–89; *Smurfit-Stone*, 2011 WL 2028076 at *14–16.

6 For a discussion on final-stage transactions, see note 96 and accompanying text.

7 *Unocal Corp v Mesa Petroleum Co*, 493 A2d 946, 954 (Del 1985).

8 *Smurfit-Stone*, 2011 WL 2028076 at *13.

9 506 A2d 173, 182 (Del 1986).

proposes the application of enhanced scrutiny under *Revlon* to all final-stage transactions.

The Comment proceeds in four parts. Part I reviews the standards by which Delaware courts scrutinize board action in the context of corporate acquisitions. Part II analyzes the stated rationale—the control premium theory—for varying judicial scrutiny based on the method of payment in corporate takeovers. This Part concludes that the focus on control premiums should be reexamined and argues that cash and stock are functionally equivalent. Part III turns to the recent Delaware mixed-consideration cases, argues that they both highlight the shortcomings of the control premium theory, and introduces a more persuasive theory of enhanced scrutiny. This idea, the final-stage transaction theory, is developed and applied in Part IV. This Comment proposes a much broader application of enhanced scrutiny in the merger context and argues that adopting this proposal would both reduce litigation costs and provide target directors with a legal incentive to resist unreasonable deal protection measures proposed by aggressive acquirers.

I. Reviewing Board Action in the Takeover Context

A. The Business Judgment Rule

The vast majority of board decisions are insulated from judicial review by the business judgment rule, which is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts.[10] Consequently, "a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be 'attributed to any rational business purpose.'"[11]

When reviewing a board decision under the business judgment rule, courts focus only on the process by which the decision was reached and do not examine its substance or outcome: "Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is *process* due care only."[12] The basic idea is straightforward: courts presume that a board knows what it is doing

10 *Aronson v Lewis*, 473 A2d 805, 812 (Del 1984) (citations omitted).

11 *Cede & Co v Technicolor, Inc*, 634 A2d 345, 361 (Del 1993) ("Cede II"), quoting *Sinclair Oil Corp v Levien*, 280 A2d 717, 720 (Del 1971).

12 *Brehm v Eisner*, 746 A2d 244, 264 (Del 2000) (citations omitted).

unless strong evidence is presented to the contrary. Hence, the business judgment rule places the burden on those who attack a board's decisions to present evidence rebutting the presumption that the directors acted properly.

Only a handful of showings will rebut this presumption. Plaintiffs must show that the board's decision was, for instance, fraudulent, illegal, wasteful, uninformed, or not disinterested.[13] If any of these elements can be shown by well-pleaded facts, the burden shifts from the plaintiffs to the defendant directors, who must now show that the contested transaction accords with the exacting entire fairness standard.[14] The narrowness of these issues is worth stressing. Fraud, illegality, and self-dealing are egregious violations of the board's duty to act in the shareholders' best interest. The vast majority of business decisions will not involve any of these issues. The narrowness of these exceptions transforms the rule from a burden-shifting presumption to the functional equivalent of an abstention doctrine. In other words, courts will not interfere with most corporate decision making absent evidence of gross misconduct.

Explanations for the business judgment rule revolve around two themes: first, judges lack commercial aptitude; and second, judicial scrutiny disturbs managerial incentives. The former justification was succinctly expressed in *Dodge v Ford Motor Co*:[15] "[J]udges are not business experts."[16] There is very little reason to think that judges will be better equipped to make sound decisions than managers themselves. One becomes an officer or director of a corporation by being a successful businessperson, while one becomes a judge by being a good lawyer. Judges have less experience making business decisions and are constrained by the limited information contained in the pleadings. According to Professor Eric Posner, "[C]ourts have trouble understanding the simplest of business relationships. . . . One survey of cases involving consumer credit, for example, showed that the judges did not even understand the concept of present value."[17]

The managerial-incentive argument is similar. The real problem is that judges do not have the same incentives to make good

13 See, for example, *Sinclair*, 280 A2d 717, 722 (Del 1971) (applying the business judgment rule when there was no evidence of fraud, gross overreaching, or self-dealing); *Shlensky v Wrigley*, 237 NE2d 776, 780 (Ill App 1968).

14 See *Cede II*, 634 A2d at 361.

15 170 NW 668 (Mich 1919).

16 Id at 684.

17 Eric A. Posner, *A Theory of Contract Law under Conditions of Radical Judicial Error*, 94 Nw U L Rev 749, 758 (2000), citing Jeffrey E. Allen and Robert J. Staaf, *The Nexus between Usury, "Time Price," and Unconscionability in Installment Sales*, 14 UCC L J 219 (1982).

decisions as corporate managers.[18] Managers are rewarded for making good business decisions; judges are not. Additionally, managers must make snap judgments; judges have time to deliberate. Given that judges have the benefit of hindsight, they may not fully appreciate the limited information upon which business decisions must be made.[19]

In economic terms, stockholders want managers who make decisions maximizing expected value. In other words, everyone would prefer a manager who chooses a plan that produces $200 one time out of ten and $0 nine times out of ten over a manager who chooses a plan that produces $10 all ten times. The first plan has twice the expected value of the second. But in a world with strict judicial review of business decisions, a judge with the benefit of hindsight might think the first plan was irresponsible.[20] Managers internalizing the threat of personal liability in future litigation would begin to prefer conservative, low expected value business plans to riskier ones with a higher expected value, thereby reducing the firm's profits over the long run.

B. Entire Fairness Review

Entire fairness, Delaware's most searching level of scrutiny, applies when "a controlling stockholder stands on both sides of a transaction."[21] The prototypical transaction subject to the entire fairness standard is a freeze out, which occurs when a controlling shareholder buys out minority shareholders without their consent.[22] The conflict of interest is plain: the minority shareholders want to be paid as much as possible while the controlling shareholder wants to pay as little as possible. The analogous situation in the takeover context is when a controlling shareholder proposes a merger with another company owned by that shareholder.[23] Courts try to minimize this

18 Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vand L Rev 83, 117–24 (2004). See generally Frederick Tung and M. Todd Henderson, *Pay for Regulator Performance* (Olin Working Paper No 574, Aug 2011), online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1916310 (visited Sept 19, 2012).

19 See Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* 100 (Harvard 1991).

20 See id at 98–99.

21 *In re Southern Peru Copper Corp Shareholder Derivative Litigation*, 2011 WL 6440761, *20 (Del Ch).

22 See, for example, *Weinberger v UOP, Inc*, 457 A2d 701, 710 (Del 1983) (applying the entire fairness standard in a cash-out merger where the controlling shareholder forced an acquisition at a depressed share price).

23 This is the situation in *Southern Peru Copper*. Then-Vice Chancellor Leo Strine nicely sketches the facts: "The controlling stockholder of an NYSE-listed mining company came to

conflict by requiring "director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders."[24]

The entire fairness standard has "two basic aspects: fair dealing and fair price."[25] Fair dealing is about process, which includes "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[26] Fair price "relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."[27] Defendant directors must demonstrate that the transaction was fair with respect to both process and price to meet the entire fairness standard.[28]

C. Enhanced Scrutiny

Enhanced scrutiny is an intermediate standard of review—much more deferential than entire fairness review, but less deferential than the business judgment rule. It is used, generally speaking, when "the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors."[29] Enhanced scrutiny is applied in contexts where application of the business judgment rule would consistently miss breaches of directors' fiduciary duties to shareholders.

The "ur-case" for application of enhanced scrutiny is directorial resistance to a hostile takeover.[30] If the takeover succeeds, the board members are almost certainly out of a job and will lose the compensation and perquisites that accompany their positions. There are also other concerns: a board that has been running a business for some time is likely to think that they have been doing a fine job and to resist the suggestion implicit in a takeover that new management could do a better job. These concerns create an "omnipresent specter

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the corporation's independent directors with a proposition. How about you buy my non-publicly traded Mexican mining company for approximately $3.1 billion of your NYSE-listed stock?" *Southern Peru Copper*, 2011 WL 6440761 at *1.

24 *In re the Walt Disney Co Derivative Litigation*, 906 A2d 27, 52 (Del 2006).

25 *Weinberger*, 457 A2d at 711.

26 Id.

27 Id.

28 Id ("[T]he test for fairness is not a bifurcated one. . . . All aspects of the issue must be examined as a whole.").

29 *Reis v Hazelett Strip-Casting Corp*, 28 A3d 442, 457 (Del Ch 2011).

30 See id.

that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[31] Under *Unocal Corp v Mesa Petroleum Co*,[32] directors who unilaterally adopt defensive measures against a hostile takeover must show "that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed"[33] and that the defensive measures[34] adopted were "reasonable in relation to the threat posed."[35]

Enhanced scrutiny also applies in situations when a company is for sale.[36] It is helpful to briefly review the facts of *Revlon*, the case that gave rise to this application of enhanced scrutiny. Ronald Perelman made a hostile tender offer for Revlon. Revlon's board decided that the offer was inadequate, and adopted defensive measures to deter Perelman. Undaunted, Perelman increased his offer. Revlon then turned to a white knight, Theodore Forstmann. After a bidding war between Forstmann and Perelman, the Revlon board accepted Forstmann's offer even though Perelman was offering more cash. The Revlon board also agreed to sell Forstmann a key Revlon asset at well below market value if anyone else acquired a substantial chunk of Revlon shares. Perelman cried foul and sued to enjoin the deal.[37]

The suit quickly went to the Delaware Supreme Court, which pronounced that, in circumstances like those described above, the duty of the target board "change[s] from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit."[38] At a certain point, reasoned the court, the question shifts from *if* the corporation will be sold to *how much* it will be sold for. Once this happens, "[t]he directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[39] The court's analysis can be understood as a special

31 *Unocal Corp v Mesa Petroleum Co*, 493 A2d 946, 954 (Del 1985).

32 493 A2d 946 (Del 1985).

33 Id at 955.

34 Defensive measures are actions taken by directors to block a hostile takeover they deem to be a threat. Examples include share repurchase programs (which make it more difficult for a hostile acquirer to purchase enough shares to gain control of the firm) and poison pills (a variety of tactics that create unpleasant consequences for potential purchasers, such as allowing target shareholders to purchase the acquirer's stock at a discount). See 19 Am Jur 2d Corporations §§ 2224–25 (2012).

35 *Unocal*, 493 A2d at 955.

36 See *Revlon*, 506 A2d at 182.

37 Id at 176–79.

38 Id at 182.

39 Id.

case of enhanced scrutiny applied to hostile takeovers. Because the corporation will ultimately be sold—effectively ending its existence—the only corporate policy that can be endangered is the maximization of short-term shareholder value. Threats to future effectiveness fade away in a sale context. Hence, defensive measures can only be justified insofar as they increase shareholder value: "Market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity."[40] A poison pill that fosters rather than ends a bidding war, for example, would likely be permissible.[41]

The extent of so-called *Revlon* duties changed dramatically in the twenty-five years since the opinion was published. In the late 1980s and early 1990s, *Revlon* was thought to put directors into a "radically altered state."[42] The duties required "immediate maximization of shareholder value" and, unlike most board obligations, were "not concerned with judgment or reasonableness."[43] Consequently, *Revlon* was perceived to allow directors "little discretion . . . compared with the business judgment rule or the *Unocal* standard."[44]

Beginning in the mid-1990s, the substance of the *Revlon* duties changed considerably. Single-minded pursuit of immediate shareholder value—effectively a mandate to take the highest price available—was replaced with an "obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders."[45] An obligation to accept the offer with the facially highest value was explicitly rejected,[46] and directors were given a list of "practical considerations"[47] that could be used in evaluating competing offers: fairness, feasibility, financing, risk of nonconsummation, bidder identity and background, and the bidder's future plans

40 *Revlon*, 506 A2d at 184.

41 See, for example, *In re Gaylord Container Corp Shareholders Litigation*, 753 A2d 462, 480 (Del Ch 2000) (explaining that poison pill defenses are permissible if they neither preclude a transaction nor force the management's preferred buyer on the shareholders).

42 *Paramount Communications Inc v Time Inc*, 1989 WL 79880, *14–15 (Del Ch). See also *TW Services, Inc v SWT Acquisition Corp*, 1989 WL 20290, *8 (Del Ch).

43 Ronald J. Rinaldi, Note, *Radically Altered States: Entering the "*Revlon *Zone*,*"* 90 Colum L Rev 760, 762–63 (1990) (quotation marks omitted).

44 Id at 763.

45 *Paramount Communications Inc v QVC Network Inc*, 637 A2d 34, 43 (Del 1993).

46 See id at 44 ("[A] board of directors is not limited to considering only the amount of cash involved."). It is important to remember that merger offers for large corporations will necessarily be complicated. As a result, there may often be ambiguity about what constitutes the best offer. Reasonable directors may have divergent preferences for nonprice terms, such as the means of financing. This rule allows them to exercise their business judgment in choosing among similarly situated offers.

47 Id.

for the corporation.[48] Finally, courts stressed that enhanced scrutiny review focused on the reasonableness of the directors' decision.[49] As long as board action is within a "range of reasonableness," "courts will not substitute their business judgment for that of the directors."[50]

This leaves an enhanced scrutiny standard with the same sensibilities as the business judgment rule. The emphasis on the range of reasonableness evinces a similar judicial respect for the difficulties of managerial decision making. But there are some important differences between the two standards. First, enhanced scrutiny entails burden shifting: directors must show that their actions were reasonable, whereas, under the business judgment rule, plaintiff shareholders must prove that the directors' actions were unreasonable. Second, even a broadly construed range of reasonableness leaves judges with more power to question managerial decision making than the business judgment rule. The latter rule has a number of narrowly defined exceptions, outside of which the directors' business judgment will be respected. Range of reasonableness review gives judges greater discretion to identify misbehavior that might not rise to the level of self-dealing or waste.

II. CURRENT CHANGE OF CONTROL DOCTRINE

The Delaware Supreme Court has set out three situations where *Revlon* requires the application of enhanced scrutiny. First, "when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company."[51] Second, when "in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company."[52] Third, when there is a sale or change of control.[53]

Whether a takeover involves a change of control depends on how the acquirer pays for the target. In cash deals, enhanced scrutiny always applies.[54] But when an acquirer pays in stock, enhanced scrutiny almost never applies. The stricter standard of review is applied only when a widely held target company comes under the control of a single majority shareholder as a result of a stock transaction. Oth-

48 Id, citing *Mills Acquisition Co v Macmillan, Inc*, 559 A2d 1261, 1282 n 29 (Del 1989).

49 See *QVC*, 637 A2d at 45 ("[A] court applying enhanced judicial scrutiny should be deciding whether the directors made *a reasonable* decision, not *a perfect* decision.").

50 Id at 45.

51 *Paramount Communications, Inc v Time Inc*, 571 A2d 1140, 1150 (Del 1989).

52 Id at 1150.

53 *Paramount Communications Inc v QVC Network Inc*, 637 A2d 34, 43 (Del 1993).

54 See id at 42–43.

erwise, stock deals are given the benefit of the more deferential business judgment rule. According to the Delaware Supreme Court, they are not change of control transactions.[55]

This Part first examines the Delaware Supreme Court's arguments for narrowly defining change of control in the *Revlon* context. It then lays out a series of arguments for and against distinguishing acquisitions by their method of payment.

A. The Control Premium Theory

In *Paramount Communications Inc v QVC Network Inc*,[56] the Delaware Supreme Court narrowly defined a change of control transaction as one in which target shareholders exchange their stock in the target corporation for either cash or a minority equity position in a corporation with a single controlling shareholder. According to the court, corporate control may be vested either in a single controlling shareholder or in a "fluid aggregation of unaffiliated stockholders."[57] When a widely held corporation acquires another company that is widely held, there is no sale of control; control is vested in an aggregate of public stockholders before and after the transaction.[58]

The change of control distinction is thought to be important because it dramatically impacts the target stockholders' voting rights. When a stock-for-stock acquisition causes the target shareholders to receive a minority equity position in a company with a single controlling shareholder, the target shareholders "los[e] the power to influence corporate direction through the ballot."[59] The controlling shareholder can unilaterally elect directors, approve a merger, cash out the public stockholders, or sell the corporation's assets.[60]

This power comes at a price, which "is usually a control premium which recognizes not only the value of a control block of shares, but also compensates the minority stockholders for their resulting loss of voting power."[61] Change of control transactions mer-

55 See id at 46–47. See also *Smurfit-Stone*, 2011 WL 2028076 at *12 ("[P]ure stock-for-stock transactions do not necessarily trigger *Revlon*. . . . [I]f ownership shifts from one large unaffiliated group of public stockholders to another, that alone does not amount to a change of control.").

56 637 A2d 34 (Del 1993).

57 Id at 46.

58 See id at 46–47.

59 Id at 43. This argument is contingent on the absence of supermajority voting rules but is easily generalizable: if *n* percent of votes are required to make corporate decisions, the controlling shareholder must end up with *n* percent of outstanding shares.

60 See *QVC*, 637 A2d at 43.

61 Id.

it particular scrutiny because minority stockholders "will have no leverage in the future to demand another control premium."[62] Control, in other words, can only be sold once.

Enhanced scrutiny is the standard for a transaction involving a change of control to ensure that target stockholders receive the highest control premium reasonably available.[63] If there is no change of control, then no control premium is exchanged.

B. Arguments for Control Premium Theory

Justifications for the change of control test fall into two categories, doctrinal and practical. According to the former, the engine driving *Revlon* scrutiny is the protection of target shareholders' ability to reverse a board's implementation of defensive measures. The latter suggests that the change of control test creates a safe harbor for excluded transactions, thereby giving directors more certainty regarding the extent of their fiduciary duties.

1. *Revlon* protects voting rights.

In a 1994 article published in the wake of *QVC*, Professor Marcel Kahan tried to piece together a "coherent and rational" explanation for the chain of takeover cases extending from *Unocal* and *Revlon* to *QVC*.[64] He argued that a principal unifying factor behind these cases was a concern that shareholders should be able to reverse directors' decisions rejecting a proposed merger.[65] When directors use defensive measures to frustrate a desirable hostile offer, shareholders could reverse their actions by appointing new directors who could roll back the defensive measures.[66] In a change of control situation, however, shareholders would lose their veto power by virtue of being cashed out or subjected to the will of a controlling shareholder.[67] As long as the company remains widely held, all unaffiliated shareholders will have the same interest in maximizing the value of their shares. Accordingly, they are just as likely to exercise their veto power over a board that fails to maximize value.[68]

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62 Id.

63 See id.

64 Marcel Kahan, Paramount *or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J Corp L 583, 585 (1994).

65 See id at 595.

66 See id at 590.

67 See id at 592.

68 See Kahan, 19 J Corp L at 595 (cited in note 64).

While this argument is coherent, it misses the point of *Revlon*: ensuring that directors do not favor one buyer over another for personal reasons in circumstances when they are particularly disposed to do so. Moreover, the means by which *Revlon* suggests that shareholders exercise their power—electing new directors and rejecting inadequate offers—is impractical at best. Staggered board provisions severely limit the power of activist shareholders to gain board control by drawing the process out over several years. Rational shareholders are unlikely to turn down any offer at a significant premium over the current share price. And doing so simply to punish a board for rejecting a higher offer is cutting off the nose to spite the face.

2. Safe harbor from *Revlon* duties.

In a 2001 lecture, then-Vice Chancellor Leo Strine of the Delaware Court of Chancery laid out a practical argument for *QVC*'s change of control test. In his words, the test has an "important, but narrow" purpose: to "create[] 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."[69] Under this view, the change of control test creates a safe harbor for stock-for-stock transactions, allowing directors to transact with a clearer view of their fiduciary duties in a given deal.

First, Strine's argument does not purport to provide substantive support for the rule. As Strine acknowledges, there is little support for the intuition that stock-for-stock transactions are qualitatively different than cash acquisitions, but this proposition is implicit in the change of control test.[70] While any arbitrary rule provides substantial certainty, a rule cannot be justified solely because it creates certainty. Creating predictable standards of conduct is a necessary but not sufficient condition of a good legal rule.

Second, as discussed below, the change of control test fails to provide directors with substantial certainty in acquisitions made with a mix of cash and stock consideration. Whether *Revlon* applies to such a case is determined by a fact-sensitive judicial inquiry, the outcome of which is uncertain.[71]

69 Leo E. Strine Jr, *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 Bus Law 919, 931 (2001).

70 Id at 929.

71 See notes 88–94 and accompanying text.

C. Arguments against Control Premium Theory

1. The fundamental rationale of *Revlon* does not compel *QVC*.

Structural bias is the fundamental concern underlying *Revlon*'s application of enhanced scrutiny to takeover negotiations. Delaware courts are suspicious that directors on their way out have insufficient incentives to faithfully carry out their fiduciary duties. The affirmative point of *QVC*'s control premium test—since control can only be sold once, its price should be maximized—is not necessarily inconsistent with *Revlon*'s premise. It is possible that control sales aggravate structural bias concerns. But as other scholars have observed, there is little reason to distinguish between a sale of control and a board's choice to dispose of all corporate assets in a stock-for-stock merger.[72] In the takeover context, all such sales implicate the fundamental concern underlying *Revlon* and, hence, should be subjected to enhanced scrutiny.

More problematic is *QVC*'s implicit negative conclusion: if control is not exchanged, there is no need for enhanced scrutiny under *Revlon*. No argument is proffered in support of this conclusion. This is surprising, as the force of the conclusion runs contrary to the basic observation of structural bias underlying *Revlon*. While control sales may aggravate structural bias concerns, stock-for-stock deals without a shift in control do not ameliorate structural bias issues. Directors are similarly situated in both contexts. Enhanced scrutiny should apply to both.

2. The market does not value control highly.

There is substantial evidence that control is not regarded as an especially precious asset by the marketplace. This takes two forms. First, empirical research has demonstrated that comparable premiums are paid in cash and stock-for-stock mergers.[73] Suppose that BuyCo, trading at $13 per share, merges with TargetCo, trading at $10 per share. The premium is any amount over $10 that TargetCo shareholders receive for their shares. In a cash deal, TargetCo shareholders might receive a 30 percent premium, or $13 per share. This is functionally identical to a 1-to-1 stock exchange where TargetCo

72 See, for example, Bernard Black and Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 Nw U L Rev 521, 536 (2002) (rejecting the doctrinal distinction between a board's decision to directly sell control for cash and its decision to "sell all of a firm's other assets through a stock-for-stock merger").

73 See Lawrence A. Hamermesh, *Premiums in Stock-For-Stock Mergers and Some Consequences in the Law of Director Fiduciary Duties*, 152 U Pa L Rev 881, 886 (2003).

shareholders would receive one share of BuyCo in exchange for every share of TargetCo they own.

A study of stock-for-stock mergers from 1999 to 2002 found that median premiums were functionally identical in stock and cash transactions: 28.26 percent in stock transactions versus 28.07 percent in cash acquisitions.[74] Mean premiums were statistically indistinguishable over the same period: roughly 30 percent in stock deals, as compared to 36 percent in cash mergers.[75] As this study suggests, acquiring a control block of shares is not the only reason that premiums are paid. The acquirer might believe that the target's management is underperforming or that synergies exist between the merging firms, or consolidation pressure in an industry may increase demand for a limited supply of existing firms. The control premium theory offers no explanation for why control premiums—narrowly defined by the courts as the amount paid to shareholders to compensate them for loss of control—should be privileged over other sorts of premiums.

According to the control premium theory, cash deals should include additional payments to compensate target shareholders for their loss of voting rights. Equivalent premiums in cash and stock acquisitions do not necessarily conflict with this position. It is possible that other types of premiums are consistently lower in cash deals. There might be, for example, systematically better management or smaller synergies in cash deals than stock deals, which would account for equal premiums even with the existence of an additional control premium in cash deals. Absent specific evidence, it seems unlikely that this is true. The control premium theory requires additional complicating assumptions in order to be consistent with existing empirical evidence. Moreover, one would intuitively expect cash acquisitions to include higher premiums than stock purchases in order to compensate shareholders for the additional tax liability involved in receiving cash.[76]

74 Id.

75 Id. This difference—20 percent higher premiums in cash acquisitions—is substantial but not statistically significant. It may well be explained by less favorable tax treatment for cash deals. Conveniently, the top capital gains rate from 1998 to 2001 was also 20 percent. See *Federal Capital Gains Tax Rates, 1988–2011* 1 (Tax Foundation 2012), online at http://www.taxfoundation.org/taxdata/show/2088.html (visited Sept 19, 2012) (documenting the rates for taxable gain recognized by target shareholders in a cash acquisition). The most important point, however, is that significant premiums are being exchanged in stock-for-stock deals. Thirty percent is not a trifle.

76 Cash acquisitions usually create a taxable gain for shareholders while stock acquisitions do not. See Hamermesh, 152 U Pa L Rev at 886 n 11 (cited in note 73), citing Samuel C. Thompson Jr, *Taxable and Tax-Free Corporate Mergers, Acquisitions and LBO's* 3 (West 1994)

Second, a recent paper tries to measure the market value of voting rights—in other words, control.[77] Using options, one can construct a "synthetic stock" with identical cash flow to common stock but with no voting rights. The difference in price between a common stock and a corresponding synthetic stock is attributable to the voting rights associated with the former. The mean annualized value of voting rights was estimated to be only 1.58 percent of the underlying stock price.[78]

Both studies point to a persuasive conclusion: most of a stock's value is derived from expected future cash flow, not voting rights. Shareholders do not demand an additional control premium in cash deals simply because they do not value their voting rights very highly. Despite this, current change of control doctrine does a better job of policing elusive, narrowly construed control premiums rather than simply ensuring that target shareholders receive the best price reasonably available in all deals.

3. Method of payment is not a strong proxy for director misbehavior.

Analysis of merger activity from 1980 to 2007 shows large variations in buyers' relative preference for using cash or stock to fund acquisitions. In the 1980s, cash was king. From 1980 to 1989, 45 percent of mergers used all-cash consideration, compared to only 33 percent all-stock deals.[79] In the 1990s, stock became dominant: 58 percent of acquisitions from 1990 to 1998 were paid wholly in stock, compared to only 27 percent of deals financed entirely with cash.[80] Mixed-consideration acquisitions were much more common in the past decade. From 2003 to 2007, approximately 25 percent of transactions used all-stock payment and 33 percent were financed wholly with cash, which means that more than 40 percent of acquisitions used a mixture of cash and stock.[81] This is a substantial increase over

("If a substantial portion . . . of the consideration paid by the acquiring corporation consists of its stock . . . the acquisition may . . . qualify as a tax-free acquisitive reorganization.").

77 See Avner Kalay, Oğuzhan Karakaş, and Shagun Pant, *The Market Value of Corporate Votes: Theory and Evidence from Option Prices* *35, 52 (unpublished manuscript, Jan 2011), online at http://ssrn.com/abstract=1747952 (visited Sept 19, 2012).

78 Id.

79 Gregor Andrade, Mark Mitchell, and Erik Stafford, *New Evidence and Perspectives on Mergers*, 15 J Econ Persp 103, 106 table 1 (Spring 2001).

80 Id.

81 See George Alexandridis, Christos F. Mavrovitis, and Nickolaos G. Travlos, *How Have M&As Changed? Evidence from the Sixth Merger Wave*, 18 Eur J Fin *5–6 table 1 (forthcoming 2012), online at http://www.tandfonline.com/doi/abs/10.1080/1351847X.2011.628401 (visited Sept 19, 2012).

the 1980s and 1990s, when 22 and 15 percent of deals, respectively, used mixed consideration.[82]

To summarize, there was a preponderance of cash deals in the 1980s, followed by a large swing toward stock transactions in the 1990s, and finally a marked decrease in stock and increase in mixed-consideration deals in the last decade. This evidence suggests that the choice of payment method in mergers and acquisitions might have more to do with prevailing macroeconomic or business trends than the likelihood of finding directorial misbehavior in individual deals.[83] It is hard to believe that mergers in the 1980s were twice as likely to be suspect as those completed in the 1990s. There is no consensus in the economic literature on what drives the method of payment, but a major 2003 paper argued that stock acquisitions are more likely in an overheated stock market.[84] When a company's management believes that the market overvalues its stock, using that stock as currency to purchase real assets becomes more attractive. Even if this particular account is not wholly persuasive, it is unlikely that shifts in the popularity of different types of deals can account for the broad swings in method of payment. Assuming, for the sake of argument, that cash deals were somehow a proxy for director disloyalty, the data would suggest that mergers in the 1980s were much more questionable than those in later decades. Alternatively, reversing the hypothetical might be clearer: if we assume that director disloyalty is relatively consistent over time, courts would have been less likely to detect it in the 1990s because the majority of transactions would have been protected from judicial scrutiny by *QVC*'s change of control doctrine.

The current rule either creates a distinction without a difference—assuming that economics alone drives the choice of payment method—or, more cynically, provides a roadmap for insulating questionable deals from judicial scrutiny. In the former story, method of payment is highly constrained by the economic realities confronting a deal. Hence, a questionable deal is no more or less likely to be all-cash or all-stock than a similarly situated deal with no *Revlon* issues. This suggests that *QVC* creates a doctrinal complication disconnected from transactional realities. Alternatively, if dealmakers

82 See Andrade, Mitchell, and Stafford, 15 J Econ Persp at 106 table 1 (cited in note 79).

83 See Alexandridis, Mavrovitis, and Travlos, 18 Eur J Fin at *2 (cited in note 81) (suggesting that access to cash and firm valuations influenced the choice of acquisition payment method in the 1990s).

84 See Andrei Shleifer and Robert W. Vishny, *Stock Market Driven Acquisitions*, 70 J Fin Econ 295, 296–97 (2003).

are sensitive to the legal rule, change of control doctrine suggests that all-stock deals should be *more* questionable than all-cash deals because nervous directors will push for a method of payment that insulates their decisions from judicial review.

4. Cash and stock are fungible.

Cash and stock consideration are functionally identical from the perspective of a target shareholder. First, a target shareholder's investment is fundamentally transformed by the merger regardless of whether he receives cash or stock. This is easy to see when cash consideration is received. The shareholder's investment is cut short and turned into cash. In stock deals, the transformation is subtler. The shareholder no longer has the investment that he wanted. Instead, he must exchange it for an equity share of the postmerger corporation. The effect is no different from the target shareholder being forced to sell his position in the target company for cash and to reinvest that money in the postmerger corporation.

Second, it is practically costless to convert publicly traded securities to cash and vice versa.[85] This is particularly true with respect to target shares after a merger announcement. Target stock usually trades at a discount to the takeover price. The discount increases as the market becomes less certain that the deal will go through. Risk arbitrageurs buy up tremendous amounts of target stock to profit from this discounting; in effect, they bet that mergers will go through. In some deals, arbitrageurs own 30 to 40 percent of the target corporation by the merger's closing date.[86] Arbitrageurs supply enormous liquidity to target shareholders who want to cash out their investment prior to a stock-for-stock deal. The success of risk arbitrage as an investment strategy also suggests that disposing of large stock positions postmerger is relatively inexpensive.[87] After all, if selling 30 percent of the outstanding shares caused stock prices to tank,

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85 See, for example, Michael J. Barclay, et al, *Effects of Market Reform on the Trading Costs and Depths of Nasdaq Stocks*, 54 J Fin 1, 32 (1999). This argument does not hold for corporations that are not exchange-traded. Such corporations, however, will tend to be small and closely held, with less separation between control and ownership. Hence, there is much less reason to be suspicious of conflicts of interest when the corporation is sold. It also sets aside tax considerations. Cash sales are a recognition event, whereas stock deals can be structured to postpone tax consequences. See Thompson, *Taxable and Tax-Free Mergers* at 3 (cited in note 76).

86 See Francesca Cornelli and David D. Li, *Risk Arbitrage in Takeovers*, 15 Rev Fin Stud 837, 838 (2002).

87 See, for example, Mark Mitchell and Todd Pulvino, *Characteristics of Risk and Return in Risk Arbitrage*, 56 J Fin 2135, 2136–38 (2001) (reporting that risk arbitrageurs achieve returns in excess of 4 percent over the market in an analysis of a sample of 4,750 mergers from 1963 to 1998).

risk arbitrage would be unprofitable. This shows that other large stockholders would similarly be able to liquidate their investments postmerger without causing the price of the stock to drop substantially.

III. THE FINAL-STAGE TRANSACTION THEORY

The crisp rules governing change of control transactions break down when applied to mixed-consideration acquisitions. The problem is that the *QVC* rule presents a binary decision: an acquisition is either a change of control or it is not. The test turns on the method of payment. Cash points one way, stock another. As a result, things get tricky when cash and stock are combined in a single transaction.

Delaware case law provides relatively little guidance. *In re Santa Fe Pacific Corp Shareholder Litigation*[88] tentatively sets a lower bound on the percentage of cash consideration necessary to trigger a change of control. In that case, the Delaware Supreme Court declined to apply *Revlon* scrutiny to a 66 percent stock, 33 percent cash deal.[89] The court did not address the *Revlon* issue squarely because the plaintiffs failed to describe the ownership structure of the acquirer. The court held that *Revlon* could not apply because "plaintiffs have failed to allege that control of [the surviving company] after the merger would not remain 'in a large, fluid, changeable and changing market.'"[90] This statement implies that the court was treating the transaction primarily as a stock acquisition because the application of *Revlon* would not turn on ownership structure in a cash acquisition. Subsequent courts have cited *Santa Fe* for the proposition that *Revlon* does not apply to a 66 percent stock transaction.[91]

In *In re Lukens Inc Shareholder Litigation*,[92] Vice Chancellor Stephen Lamb of the Delaware Court of Chancery opined that a 62 percent cash, 38 percent stock acquisition should trigger enhanced scrutiny under *Revlon*.[93] The court did not address the issue at length

88 669 A2d 59 (Del 1995).

89 Id at 63–65.

90 Id at 71, quoting *Arnold v Society for Savings Bancorp, Inc*, 650 A2d 1270, 1290 (Del 1994).

91 See *Smurfit-Stone*, 2011 WL 2028076 at *15; *In re Lukens Inc Shareholders Litigation*, 757 A2d 720, 732 n 25 (Del Ch 1999) (distinguishing *Santa Fe* but implicitly considering it as controlling precedent for a deal involving 33 percent cash and 66 percent stock).

92 757 A2d 720 (Del Ch 1999).

93 See id at 732 n 25 (expressing in dicta that a deal involving more than 60 percent cash will constitute a change of corporate control). The case did not turn on the issue because the court held that the complaint must be dismissed whether or not *Revlon* was implicated. See id at 732–33.

but reasoned that, because a substantial portion of the deal was in cash, *Revlon* scrutiny should apply.[94]

These two cases highlight the challenges that mixed-consideration cases create for the control premium theory. A deal must be filed into one of two categories: it is either treated as a wholly cash acquisition, as in *Lukens*, or as a stock-for-stock merger, as in *Santa Fe*. If, for example, the deal is treated as a cash acquisition, the stock portion of the consideration is effectively ignored. Control premium theory offers no explanation for why we should ignore the nondominant portion of the consideration. These cases also demonstrate the arbitrariness of looking at the consideration. Is a 60 percent stock deal fundamentally different from one evenly split between stock and cash?

Two recent Court of Chancery cases considering the application of *Revlon* to mixed-consideration transactions suggest a way out of this quandary by reconceptualizing enhanced scrutiny under *Revlon*.[95] Instead of focusing on the future availability of a control premium, these cases consider whether the deal is a final-stage transaction. The idea is clearest when the deal is all or mostly cash: it is the last chance for the cashed-out shareholders to get the maximum value for their shares. But one of these recently decided cases, *Steinhardt*, suggests that the final-stage transaction theory is equally applicable to acquisitions financed largely with the acquirer's stock.[96] This Part more fully explores the law and policy underlying the final-stage transaction conception of *Revlon*.

A. Tracing the History of the Final-Stage Transaction Theory

Delaware courts have been thinking about final-stage transactions for more than two decades. They were first discussed in the late 1980s as an elaboration of the relationship between enhanced scrutiny under *Unocal* and *Revlon*.[97] In the years since, however, the idea has become an independent rationale for taking a closer look at transactions that irreversibly change shareholders' equity interest in a corporation.

94 See id (noting that there is no bright-line rule establishing the proportion of cash that causes a change of control, but holding that 60 percent is enough).

95 See *Steinhardt*, No 5878–VCL, transcript op at *86–87 (explaining that the change of control test is properly understood as a proxy for a final-stage transaction); *Smurfit-Stone*, 2011 WL 2028076 at *14 (holding that *Revlon* scrutiny applies to a deal in which half the shareholders' interest would be cashed out because the deal represented the last opportunity for shareholders to realize a return on this half of their investment).

96 *Steinhardt*, No 5878–VCL, transcript op at *87–88.

97 For a discussion of the *Revlon* and *Unocal* cases, see Part I.C.

The final-stage transaction idea first appeared in a 1989 Court of Chancery opinion by then-Chancellor William Allen, *TW Services, Inc v SWT Acquisition Corp*.[98] The court eloquently states the basic idea underlying the duty to maximize shareholder value in a cash transaction:

> In the setting of a sale of a company for cash, the board's duty to shareholders is inconsistent with acts not designed to maximize present share value, acts which in other circumstances might be accounted for or justified by reference to the long run interest of shareholders. *In such a setting, for the present shareholders, there is no long run.* For them it does not matter that a buyer who will pay more cash plans to subject the corporation to a risky level of debt, or that a buyer who offers less cash will be a more generous employer for whom labor peace is more likely. The rationale for recognizing that non-contractual claims of other corporate constituencies are cognizable by boards, or the rationale that recognizes the appropriateness of sacrificing achievable share value today in the hope of greater long term value, is not present when all of the current shareholders will be removed from the field by the contemplated transaction.[99]

TW Services conceives of *Revlon* as a special case of *Unocal*: when an all-cash offer is contemplated, the only judicially cognizable harm to shareholders is that they might not receive the highest value possible for their shares. As a result, defensive measures may only be taken to draw in higher bids for the corporation. This is precisely what *Revlon* refers to when it describes the transformation of directors from "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[100]

According to this argument, the sale of a company for cash collapses shareholders' investment horizon to the immediate future. The current owners of the company have no reason to be concerned about the surviving corporation's welfare after they have been cashed out. The implicit corollary is that the business judgment rule might not be applicable in this context. Normally, shareholders want management to put substantial long-term profits ahead of smaller short-term gains. The business judgment rule protects such decisions from judicial review for fear that a judge might mistake long-term

98 1989 WL 20290 (Del Ch).
99 Id at *7 (emphasis added) (citations omitted).
100 *Revlon*, 506 A2d at 182.

savvy for short-term stupidity. But such mistakes are less likely in the context of a cash sale, when the relative value of a transaction is readily quantifiable.

The Court of Chancery reiterated this idea in *Mendel v Carroll*,[101] which addressed the duties of a board to minority shareholders when a single shareholder (or, as in *Mendel*, a group of like-minded shareholders) owns a controlling block of shares. *Mendel* reasoned that when the controlling shareholders endorse a buyer's cash-out tender offer, the board has a duty to ensure that "it would be accomplished only on terms that were fair to the public shareholders and represented the best available terms from their point of view."[102] A cash-out merger "is a final-stage transaction for the public shareholders. Thus, the time frame for analysis, insofar as those shareholders are concerned, is immediate value maximization. The directors are obliged in such a situation to try, within their fiduciary obligation, to maximize the current value of the minority shares."[103]

Significantly, the *Mendel* court conceives of the final-stage transaction concept as closely related to the other justifications for *Revlon* scrutiny. It observes that the obligation to maximize shareholder value is "analogous to the board's duty when it is engaged in a process of selling the corporation, as for example in [*QVC*]."[104] The duties are different in *Mendel* only because of the control block owned by shareholders acting in concert. The reasoning of *Mendel* was adopted wholesale by the Delaware Supreme Court in *McMullin v Beran*.[105]

This thread is picked up in the context of mixed-consideration acquisitions by *Lukens*, which noted in dictum that a 62 percent cash, 38 percent stock deal should be scrutinized under *Revlon*.[106] The defendants argued that "because over 30% of the merger consideration was shares of . . . a widely held company without any controlling shareholder, *Revlon* and *QVC* do not apply."[107] This is a defensible argument under a broad conception of the control premium theory. Target shareholders will still have a shot at another control premium

101 651 A2d 297 (Del Ch 1994).

102 Id at 306.

103 Id.

104 Id (quotation marks omitted).

105 765 A2d 910, 918 (Del 2000) ("Whenever the board is deciding whether to approve a proposed 'all shares' tender offer that is to be followed by a cash-out merger, the decision constitutes a final-stage transaction for all shareholders. Consequently, the time frame for the board's analysis is immediate value maximization for all shareholders."), citing *Mendel*, 651 A2d at 305.

106 See *Lukens*, 757 A2d at 725, 732 n 25.

107 Id at 732 n 25.

to the extent that they obtain shares of widely held stock. The counterargument is, relative to an all-stock deal, shareholders will only receive one-third as much of any future control premium.

Then-Vice Chancellor Lamb's reasoning focuses on the extent to which cash consideration ends the shareholders' interest in the newly merged firm:

> I cannot understand how the Director Defendants were *not* obliged, in the circumstances, to seek out the best price reasonably available. . . . Whether 62% or 100% of the consideration was to be in cash, the directors were obliged to take reasonable steps to ensure that the shareholders received the best price available because, in any event, for a substantial majority of the then-current shareholders, "there is no long run."[108]

For target shareholders, the merger negotiations are their last chance to receive substantial value in return for their shares. This alone is a good reason to impose enhanced scrutiny. Because a cash sale is the last chance for a shareholder to realize any of the value inherent in the stock—whether voting rights, future appreciation, or expected dividends—that value is protected by imposing on target directors a duty to obtain the highest reasonable price.

The final-stage-transaction idea set out in *Lukens* continues to have a vital influence on the Delaware Court of Chancery.[109] A recent mixed-consideration case, *Smurfit-Stone*, turned largely on an application of *Lukens*'s reasoning to a corporate acquisition where consideration was evenly split between cash and the acquirer's stock. The court held that *Revlon* enhanced scrutiny should apply to the transaction because it "constitute[d] an end-game for all or a substantial part of a stockholder's investment in a Delaware corporation."[110]

These more recent cases help us understand that the difference between the business judgment rule and *Revlon* enhanced scrutiny lies in more searching judicial review and the shifted burden, not in the underlying fiduciary duties imposed on the director. *Lukens* and *Smurfit-Stone*, unlike *Mendel* or *TW Services*, do not couch the application of *Revlon* duties in terms of a shortened time frame for evaluating director action. As the Delaware Supreme Court noted in *Time*, "the question of long-term versus short-term values is largely irrelevant because directors, generally, are obliged to chart a course

108 Id, quoting *TW Services*, 1989 WL 20290 at *7.

109 See, for example, *Air Products and Chemicals, Inc v Airgas, Inc*, 16 A3d 48, 101–03 (Del Ch 2011).

110 *Smurfit-Stone*, 2011 WL 2028076 at *14.

for a corporation which is in its best interests without regard to a fixed investment horizon."[111] Directors are always obliged to maximize value; this is the core of the duty of loyalty. Imposing *Revlon* duties on directors only strips the favorable presumption of the business judgment rule, which forces them to bear the burden of demonstrating that their actions were indeed reasonably directed at maximizing value. The *Lukens* court makes this explicit: "Although this court and the [Delaware] Supreme Court may use the term to categorize certain claims, there are no special and distinct *Revlon* duties."[112]

The duty to reasonably maximize value derives not from the shareholders' investment time frame collapsing into the immediate transaction, but rather it is a more general concern stemming from the importance of a transaction in which shareholders have no further recourse to the market. To the *Lukens* court, *Revlon* is "an important comment on the need for heightened judicial scrutiny when reviewing situations that present unique agency cost problems."[113] Because final-stage transactions are irreversible, they present a "unique agency cost."[114] In most business contexts, the best shareholders can hope for is that management makes more good decisions than bad. Managerial prowess can only be determined in the long run. A merger or takeover is, by definition, a one-shot deal. Agency costs in such situations are therefore a real loss to shareholders.

B. The Last-Period Problem

The Delaware Court of Chancery has recently identified another "unique agency cost"[115] that justifies imposing enhanced scrutiny on final-stage transactions: last-period problems.[116] Repeated interactions with another party create nonlegal constraints on behavior. If, for example, you borrow your neighbor's lawnmower, it makes sense to return it promptly and in good condition so that you can borrow it again in the future. The last-period problem crops up when repeated interactions come to an end. You would have less incentive to return your neighbor's lawnmower in good condition if you knew you were

111 *Paramount Communications, Inc v Time Inc*, 571 A2d 1140, 1150 (Del 1989) (quotation marks omitted).

112 *Lukens*, 757 A2d at 731 (quotation marks omitted) (specifying that *Revlon* duties simply refer to "a director's performance of his or her duties of care, good faith, and loyalty in the unique factual circumstance of a sale of control").

113 Id (concluding that "*Revlon* did not fundamentally alter Delaware's corporate law").

114 Id.

115 Id.

116 See *Reis v Hazelett Strip-Casting Corp*, 28 A3d 442, 458–59 (Del Ch 2011).

moving away the next week. Another good example of last-period behavior is the flurry of pardons issued by most presidents during their final days in office.[117]

In *Reis v Hazelett Strip-Casting Corp*,[118] the Delaware Court of Chancery drew on a wealth of scholarly work exploring last-period problems in corporate governance issues.[119] Generally, continued involvement with a firm decreases incentives to self-deal. Directors and officers do not want to lose compensation or suffer the negative reputational effects of being fired: "[T]he ability of managers to shirk or self-deal ordinarily is constrained not only by legal duties but also by a range of markets . . . . But when managers are in their final period, market consequences have less traction, making managers more likely to favor their own interests."[120]

The concern in final-stage transactions is not dastardly conduct by management—outright lying and cheating are probably rare among managers freed from market constraints. Instead, "the last period signals a time when otherwise common behavioral biases may lead to serious deviations from the welfare of the corporation and its shareholders."[121] Cognitive errors that lead to bad judgment are exacerbated in last-period situations. *Revlon* jurisprudence is full of such examples, starting with *Revlon* itself. In that case, target directors were unduly influenced by two factors: first, the "strong personal antipathy" borne by Revlon's CEO toward the hostile acquirer; and second, the directors' "emphasis on shoring up the sagging market value of [Revlon-issued debt instruments] in the face of threatened litigation by their holders."[122]

117 See Neal Kumar Katyal, *Internal Separation of Powers: Checking Today's Most Dangerous Branch from Within*, 115 Yale L J 2314, 2345 (2006) (pointing to President Bill Clinton's last-minute pardons as an example of a last-period problem).

118 28 A3d 442 (Del Ch 2011).

119 For examples of such scholarly work, see Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 NYU L Rev 733, 848–53 (2005) (noting, in the context of an extended exploration of the role of altruism in the boardroom, that the imposition of the *Revlon* standard is justified by last-period problems); Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 Fordham L Rev 1899, 1904–05 (2003) (arguing that Delaware deal-protection jurisprudence can be explained in terms of the last-period problem); William J. Carney, *Controlling Management Opportunism in the Market for Corporate Control: An Agency Cost Model*, 1988 Wis L Rev 385, 423 (observing that, for directors contemplating the self-serving rejection of a takeover bid, fear of shareholder reprisal is offset "by the probability that a successful takeover will mean no salary at all").

120 *Reis*, 28 A3d at 458.

121 Griffith, 71 Fordham L Rev at 1948 (cited in note 119) (examining how selective information processing, self-serving bias, and in-group bias can subconsciously influence the decisions of corporate actors).

122 *Revlon,* 506 A2d at 176, 182.

Because decisions made in the last period of a corporate sale will be relatively unconstrained by market forces, legal constraints on managerial discretion are warranted. *Reis* argues that enhanced scrutiny for final-stage transactions serves just this function: "In recognition that potentially subtle conflicts can affect director decision-making, enhanced scrutiny places the burden on the defendant fiduciaries who approved the final stage transaction to show that they acted reasonably to obtain for their beneficiaries the best value reasonably available under the circumstances."[123]

C. *Steinhardt*: Enhanced Scrutiny for Final-Stage Transactions

In a bench decision in *Steinhardt*, the Delaware Court of Chancery held that a 50 percent cash, 50 percent stock acquisition triggered enhanced judicial scrutiny under *Revlon*.[124] The court made a series of novel arguments that suggest at least some members of the Delaware judiciary believe enhanced scrutiny should be applied to all final-stage transactions. While the opinion does not fully explore this crucial concept, its reasoning implies a broad application of *Revlon* enhanced scrutiny to both cash and stock-for-stock acquisitions.

Steinhardt holds that enhanced scrutiny applies when there is a final-stage transaction, characterized as "a situation where the target stockholders are in the end stage in terms of their interest in [the business]."[125] According to the court, *QVC*'s change of control test "is ultimately a derivative test."[126] Change of control is simply a clear-cut example of a final-stage transaction: Target shareholders can be cashed out of the surviving corporation at any time. Their ownership interest in the surviving company is fundamentally transformed by the emergence of a controlling shareholder.

The key factor that determines if a deal is a final-stage transaction is whether it "is the only chance [target shareholders] have to have their fiduciaries bargain for a premium for their shares as the holders of equity interests in [the target company]."[127] This is straightforward in cash acquisitions: "If you want more cash for your shares, this is the only time you have to get it."[128] Once the

123 *Reis*, 28 A3d at 459 (reasoning that the risk of cognitive biases among board members can support the application of the *Revlon* standard).

124 *Steinhardt*, No 5878–VCL, transcript op at *89.

125 Id at *86–87.

126 Id at *86.

127 Id at *87.

128 *Steinhardt*, No 5878–VCL, transcript op at *87.

acquisition is finalized, the target shareholders will exchange their equity interest for a set amount of cash. They cannot renegotiate or object to the exchange.

Steinhardt's most novel argument is that the exact same dynamic exists in stock-for-stock deals. But, instead of bargaining for a final exchange for cash, the target's fiduciaries are bargaining for the "amount of interest [target shareholders are] going to have in the post-transaction entity."[129] The greater the exchange ratio between the acquirer's and the target's stock, the larger the target shareholders' interest in the post-transaction entity. Although the court does not make this point, the shares are a liquid asset that can easily be reduced to cash. Receiving more of the acquirer's shares in exchange for target stock is functionally identical to receiving more cash.[130]

The court takes pains to fit its argument into the framework laid out by *QVC*:

> We often talk about, oh, well, but the stockholders can get a future control premium. That's all well and good for the future entity, but what you're bargaining over now is how much of that future premium you're going to get.
>
> . . .
>
> This is the only opportunity where you can depend upon your fiduciaries to maximize your share of that value.[131]

This is the same dynamic seen when the consideration is cash. As a general matter, target shareholders rely on their fiduciaries to maximize the consideration they receive for their equity interest. Similarly, the exchange is final regardless of the method of payment.

Note that the court is concerned about premiums generally, not just control premiums narrowly defined as what is paid to compensate for a loss of voting rights. *Steinhardt*'s hypothetical nicely illustrates this point. Say that Calix—Occam Networks's acquirer—"becomes an attractive acquisition target, and that one of the big boys picks it up at some point for a healthy premium."[132] Here, "healthy premium" clearly means some amount in excess of the market price. There is no reason to distinguish between selling Calix eventually for cash or stock, or whether its hypothetical acquirer has a controlling shareholder.

129 Id at *87.

130 See Part II.C.4.

131 *Steinhardt*, No 5878–VCL, transcript op at *87–88.

132 Id at *87.

Shareholders should be fully compensated for all rights that constitute an equity interest in a corporation, not just voting rights. As discussed above, there is little reason to distinguish between a stock's value insofar as it represents a future income stream, whether by receipt of dividends or by sale at a higher price, and its value insofar as it represents a voting right.[133] Indeed, from a quantitative perspective, the residual claim is far more valuable than the voting right.

Steinhardt argues that enhanced scrutiny should be imposed on final-stage transactions because a merger is a transformative event for shareholders. Their equity will be transformed into either cash or securities, and the exchange is final. How much they get for each share must be negotiated by their fiduciaries. Once the acquisition takes place, there is nothing more that shareholders can do. They have no effective remedy if directors were self-dealing or shirking. Enhanced scrutiny puts the burden on directors to show that the sale process was reasonably directed at maximizing shareholder value, ensuring that this transformative event is conducted reasonably well.

IV. A PROPOSED FRAMEWORK FOR THE APPLICATION OF ENHANCED SCRUTINY

Delaware Supreme Court precedent is relatively unambiguous on the application of *Revlon*. The duty "to seek the transaction offering the best value reasonably available to the stockholders"[134] arises

> (1) when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company;
>
> (2) where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company; or
>
> (3) when approval of a transaction results in a sale or change of control.[135]

Modern *Revlon* litigation turns on the last scenario: whether a transaction constitutes a sale or change of control. Recall that under

133 See Part II.C.2.

134 *QVC*, 637 A2d at 43.

135 *Arnold v Society for Savings Bancorp*, 650 A2d 1270, 1290 (Del 1994) (quotation marks and citations omitted).

QVC, there is no change of control when "control of both [companies] remain[s] in a large, fluid, changeable and changing market."[136]

Steinhardt suggests an expansion of *Revlon*. It argues that the determinative factor in applying enhanced scrutiny under *Revlon* is whether the approval of the acquisition results in a final-stage transaction.[137] Most controversially, the opinion suggests that stock-for-stock transactions are just as final as cash acquisitions. It is difficult to square this with existing change of control doctrine.

This Part provides a framework that the Delaware Supreme Court could use to integrate the change of control and final-stage transaction theories. It suggests that Delaware courts could add a new basis—as they did in *QVC*—for the application of enhanced scrutiny under *Revlon*: whether the proposed takeover is a final-stage transaction. First, broadening the application of *Revlon* to a wide swath of business combinations unites existing legal doctrine with the observations about agency costs at the heart of *Revlon*. Second, the judicial understanding of *Revlon* has changed significantly in the fifteen years since *QVC* was decided. It is now quite clear that *Revlon* does not impose an "auction duty" or create a "radically altered state" for directors.[138] Moreover, *Revlon* has become almost entirely process-focused, essentially imposing the same duties as *Smith v Van Gorkom*[139]—that is, requiring informed and deliberative decision making in a reasonable time frame—but with the burden on directors to show that they made a decision informed by a reasonable, deliberative process, rather than on the plaintiffs to show that they did not. The result is an enhanced scrutiny doctrine narrowly tailored to smoke out and deter subtle conflicts of interest that can affect director decision making.

A. Enhanced Scrutiny for All Final-Stage Transactions

Steinhardt's reasoning suggests imposing enhanced scrutiny on all takeovers that are final-stage transactions. Such transactions implicate the fundamental concern of *Revlon*: target directors might allow "considerations other than the maximization of shareholder profit to affect their judgment" in merger negotiations.[140]

Final-stage transactions present three issues that aggravate *Revlon*'s core concern. First, they might result in all or most directors

136 *QVC*, 637 A2d at 47.
137 *Steinhardt*, No 5878–VCL, transcript op at *86.
138 See *Lyondell Chemical Co v Ryan*, 970 A2d 235, 243 (Del 2009).
139 488 A2d 858 (Del 1985).
140 *Revlon*, 506 A2d at 185.

and senior officers losing their positions with the target corporation.[141] Under such pressures, directors might be tempted to favor an offer that puts their own interests (pecuniary or otherwise) over those of shareholders. Second, final-stage transactions irrevocably transform target shareholders' equity interest. Once an acquisition has been approved, it is nearly impossible to undo. High stakes justify enhanced scrutiny. Moreover, regardless of whether he receives cash or stock as consideration, a shareholder's property interest is fundamentally changed. Shareholders have only one opportunity to get as much for their shares as possible. Finally, last-period effects exacerbate these structural concerns. Officers and directors are significantly less constrained by market consequences in their last period of employment. As a result, courts should be particularly suspicious of decisions made in these periods when there are substantial opportunities for self-dealing combined with high stakes.

The result effectively imposes enhanced scrutiny on all takeovers, regardless of payment method. *Steinhardt*'s key insight is that there is no reason to elevate form over substance by distinguishing between stock and cash acquisitions. Shareholders demand comparable premiums no matter how they are compensated for their interest in the target corporation.[142] Finally, the two forms of consideration are almost always completely fungible. Shareholders receiving stock can costlessly convert it into cash and vice versa.

Yet, apart from the consideration point, this proposal is quite similar to the Delaware Supreme Court's holding in *QVC*. A central reason for scrutinizing the board action at issue in that case was "the fact that an asset belonging to public stockholders (a control premium) is being sold and may never be available again."[143] A change of control is merely a specific example of a final-stage transaction: the final opportunity for shareholders to be compensated for their voting rights. The reality, however, is that control is not highly valued by the marketplace.[144] *Steinhardt* suggests taking the core intuition of *QVC*—a concern about last chances—and applying it broadly.

It seems that much of what motivated the early 1990s change of control jurisprudence was the perception that *Revlon* imposed highly burdensome duties on directors. The last decade has made it clear

141 See James P. Walsh, *Top Management Turnover Following Mergers and Acquisitions*, 9 Strategic Mgmt J 173, 177 (1988).

142 See notes 73–74 and accompanying text.

143 *QVC*, 637 A2d at 45.

144 See Part II.C.2.

that this is not the case. Enhanced scrutiny under *Revlon* is similar to enhanced scrutiny under *Unocal*, and neither is necessarily outcome-determinative. The current view looks almost exclusively to process and focuses on the reasonableness of director actions. The Delaware Supreme Court has repeatedly stressed that there are no special *Revlon* duties.[145] The key difference from the business judgment rule is shifting the burden to directors to show that they acted reasonably. This is appropriate in situations such as takeovers where directors might frequently be tempted to focus on nonshareholder considerations, and market constraints cannot be relied upon to restrain such behavior.

B. Applying *Revlon* Enhanced Scrutiny to Final-Stage Transactions Is a Logical Extension of Existing Doctrine

A broad application of enhanced scrutiny to corporate acquisitions and mergers not only comports with the intuition underlying *Revlon* but is also a logical extension of existing Delaware law.

Two cases from the Delaware Supreme Court establish the content and limits of the change of control doctrine: *Paramount Communications, Inc v Time Inc*[146] and *QVC*. *Time* is associated with the proposition that stock-for-stock transactions do not trigger *Revlon* duties. The text of the decision is a bit more complicated. Nowhere in the court's opinion is this broad principle announced. At most, the court holds that a particular stock-for-stock deal (the Time-Warner merger) does not trigger *Revlon*. The reasoning is firmly grounded in the language of the *Revlon* opinion: "[We] do not find in Time's recasting of its merger agreement with Warner from [a stock to cash transaction] a basis to conclude that Time had either abandoned its strategic plan or made a sale of Time inevitable."[147]

To the extent that *Time* announced a broad principle, it was in then-Chancellor Allen's unpublished opinion for the Court of Chancery.[148] That opinion supplied the reasoning—and much of the language—that the court used in *QVC*. The key idea driving the opinion was the observation that "aside from legal technicalities . . . neither corporation could be said to be acquiring the other."[149] The specific facts of *Time* support this conclusion: the two companies

145 See, for example, *Lyondell*, 970 A2d at 239 (Del 2009) ("*Revlon* did not create any new fiduciary duties.").

146 571 A2d 1140 (Del 1989).

147 Id at 1151.

148 See *Paramount Communications Inc v Time Inc*, 1989 WL 79880, *23 (Del Ch).

149 Id.

were in the same line of business, comparably sized, and the merger was the result of years of discussion.[150] Moreover, the Court of Chancery took the view that "to be in a Revlon mode is for a director to be in a radically altered state."[151] The decision was fueled by a concern that expanding *Revlon* would "dramatically restrict the functioning of the board whenever an offer was made."[152]

But the court chose to affirm then-Chancellor Allen's decision on other grounds. On the one hand, the court expressly approved of the opinion and wrote that "[t]he Chancellor's findings of fact are supported by the record and his conclusion is correct as a matter of law."[153] Nevertheless, the court distanced itself from the Chancellor's reasoning: "[W]e premise our rejection of plaintiffs' *Revlon* claim on different grounds, namely, the absence of any substantial evidence to conclude that Time's board, in negotiating with Warner, made the dissolution or break-up of the corporate entity inevitable, as was the case in *Revlon*."[154] This evinces an understandable conservativeness on the part of the Delaware Supreme Court. Corporate leaders want certain and predictable rules to govern their rights and obligations—adding wrinkles and nuances to the law moves Delaware jurisprudence away from that position.

The Delaware Supreme Court waited four years before adopting then-Chancellor Allen's proposed change of control test in *QVC*. That decision fleshed out the Chancery Court's ideas about change of control with a focus on protecting the imperiled control rights of target shareholders by ensuring an adequate control premium. The new change of control test was joined with a strong emphasis that enhanced scrutiny was a range of reasonableness test that gave directors broad latitude to use their business judgment in navigating the murky waters en route to "investigating and selecting the best value reasonably available."[155] But as discussed above, *QVC* gives no account for why enhanced scrutiny should *not* apply when there is not a change of control.[156]

Steinhardt's interpretation of *Revlon* scrutiny answered this ambiguity and elaborated on the final-stage transaction theory without disturbing the framework laid out in *QVC*. It observed that a narrow

150 See *Time*, 571 A2d at 1144–46.

151 *Time*, 1989 WL 79880 at *25.

152 Id (rejecting the plaintiff's argument for an "extension of *Revlon* beyond sales or other change in control transactions").

153 *Time*, 571 A2d at 1150.

154 Id.

155 *QVC*, 637 A2d at 45.

156 See Part II.C.1.

focus on control premiums overlooks transactions with real agency costs—precisely the concern that animated the original *Revlon* decision. This change reflected an evolving understanding of the concerns underpinning *Revlon*. Delaware law has considered the last-period problem, both in scholarly commentaries and case law. Research continues to show the minimal value of voting rights and, accordingly, the somewhat illusory value of *QVC*'s narrowly defined control premium. One of the key rationales for the application of enhanced scrutiny in *QVC*—"the fact that an asset belonging to public stockholders (a control premium) is being sold and may never be available again"[157]—is mirrored by *Steinhardt*'s concern for irreversible losses to shareholders in the final-stage transaction theory.

If taken seriously, *Steinhardt* suggests a change to *Revlon* jurisprudence analogous to what was wrought in *QVC*. That court was confronted with a deal that might not have merited enhanced scrutiny under the then-recognized scenarios triggering *Revlon* duties. Paramount strenuously argued that *Revlon* could not apply in the absence of a break-up of the corporation.[158] The court in *QVC* rejected that argument, and in so doing, created a new test for the application of enhanced scrutiny under *Revlon*—the change of control test. It makes sense, then, that *QVC* is more concerned with justifying the applicability of its new test than foreclosing the possibility of further additions to *Revlon* jurisprudence. *Steinhardt* presents a sensible addition to the *Revlon* triggers by showing that another type of transaction warrants enhanced scrutiny under *Revlon*.

Both the change of control and final-stage transaction tests effectively absorb their predecessors. After *QVC*, the primary issue was whether a transaction constituted a change of control. *Steinhardt* suggests that we should also look to whether a transaction is in its final stage. Additionally, both change of control and the final-stage transaction theories were presaged by previous Delaware Supreme Court cases. The final-stage transaction theory runs parallel to *QVC*'s change of control doctrine. Both flesh out *Revlon*'s core insight that certain kinds of transactions warrant further scrutiny by the courts. While some final-stage transactions would not have been considered changes of control under *QVC*, this does not mean that adopting the former requires overruling the latter. The same dynamic was created by *QVC*. Some change of control transactions also implicated previously existing parts of the *Revlon* test, initiating

157 *QVC*, 637 A2d at 45.

158 See id at 46.

an active bidding process and responding to a bidder's offer.[159] But *QVC* surely did not overrule or change those parts of the existing *Revlon* test. The importance of change of control was illustrated in cases like *Mills Acquisition Co v Macmillan, Inc*[160] and *Barkan v Amsted Industries, Inc*,[161] both of which preceded *QVC* by several years.[162] Similarly, *McMullin* recognized the possibility that final-stage transactions might implicate *Revlon* scrutiny even when a merger does not involve a change of control.[163]

C. Delaware's Evolving Understanding of *Revlon* Is Well Tailored to Address Subtle Final-Stage Transaction Issues

Delaware courts' application of *Revlon* has evolved considerably since *Time* and *QVC*. The *Time* court framed the question of whether *Revlon* applied in strict terms. If a duty to maximize value applied, Time's board would "come under a fiduciary duty to jettison its [long-term strategic] plan and put the corporation's future in the hands of its shareholders."[164] The Court of Chancery's opinion in *Time* was similarly dramatic, characterizing *Revlon* as creating a "radically altered state" in which a board's duty becomes "the good faith pursuit of immediate maximization of share value."[165] This conception strips substantial discretion from a board of directors. One can understand why *Revlon* made directors anxious; they could face personal liability for favoring a course of action they genuinely believed would lead to greater long-run profits over one with a larger immediate gain in short-term values.

QVC moderated this anxiety to some extent by stressing that *Revlon* review is about reasonableness. Courts were instructed not to "ignore the complexity of the directors' task in a sale of control."[166]

159 See text accompanying notes 51–53.

160 559 A2d 1261 (Del 1989).

161 567 A2d 1279 (Del 1989).

162 See *Macmillan*, 559 A2d at 1288 ("[I]n a sale of corporate control the responsibility of the directors is to get the highest value reasonably attainable for the shareholders."); *Barkan*, 567 A2d at 1286 ("We believe that the general principles announced in *Revlon* . . . govern this case and every case in which a fundamental change of corporate control occurs or is contemplated.").

163 See *McMullin*, 765 A2d at 918–19. See also *Omnicare, Inc v NCS Healthcare, Inc*, 818 A2d 914, 929 n 21 (characterizing *McMullin* as implicating *Revlon* duties "where the board agreed to sell the entire company, even though the merger did not involve a 'change of control'").

164 *Time*, 571 A2d at 1149–50.

165 *Time*, 1989 WL 79880 at *20.

166 *QVC*, 637 A2d at 45.

Enhanced scrutiny requires only "*a reasonable* decision, not *a perfect* decision."[167]

1. *Revlon* scrutiny examines process, not substance.

Enhanced scrutiny under *Revlon* has two key features: "(a) a judicial determination regarding the adequacy of the decisionmaking process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing."[168] A 2010 Court of Chancery opinion, *In re Dollar Thrifty Shareholder Litigation*,[169] summarizes these factors. *Thrifty* characterizes the first part of the *Revlon* inquiry as asking: Is the board "truly well motivated (i.e., is it acting for the proper ends?)."[170] The practical effect of this is that "[t]he court must take a nuanced and realistic look at the possibility that personal interests short of pure self-dealing have influenced the board to block a bid or to steer a deal to one bidder rather than another."[171] Note that this approach aligns nicely with the concerns associated with structural bias generally and, more specifically, the last-period problem. When directors are effectively putting themselves out of a job, we are more suspicious that subtle conflicts of interest might interfere with their performance and less confident that market constraints will deter such behavior.

Under this view, *Revlon*'s second part, which inquires into the reasonableness of director action, is merely a check to ensure that the directors' actions demonstrate the same intent as their stated motives. "[T]he court seeks to assure itself that the board acted reasonably, in the sense of taking a logical and reasoned approach for the purpose of advancing a proper objective, and to thereby smoke out mere pretextual justifications for improperly motivated decisions."[172] Hence, the court will sometimes look past empty justifications when the directors' actions are unreasonable. The emphasis here is on *sometimes*. The more credible the board's "good faith desire to attain the proper end," the more likely the court is "to defer to the board's

167 Id (emphasizing that *Revlon* duties do not require idealized value maximization, but merely an effort to secure "the best value reasonably available").

168 Id.

169 14 A3d 573 (Del Ch 2010).

170 Id at 599–600.

171 Id at 598.

172 Id.

judgment about the means to get there."[173] As a result, when the board appears to be "well-motivated and careful," judicial second-guessing of their decisions should be rare.[174]

The result is a standard under which deference is keyed to the likelihood of finding misconduct. Where a board's motives appear to be sound, its actions must be highly inappropriate to trigger a finding of unreasonableness. But if the board's motives are suspect, judicial review of its actions will be more searching.

2. Mild remedies for subtle problems, stiff accountability for serious misbehavior.

The interaction between *Revlon* enhanced scrutiny and exculpation provisions in most corporate charters creates a dynamic system of remedies where the consequences of misbehavior are proportional to its severity. According to *Lyondell*, the most recent Delaware Supreme Court decision to closely examine *Revlon*, a showing of bad faith—characterized as "intentional dereliction of duty"—is required to find directors personally liable in the face of an exculpation provision.[175] Demonstrating intentional bad faith will be difficult in most cases. Barring such a showing, penalties for violations of *Revlon* enhanced scrutiny will be limited to injunctions. This is enough of an inconvenience to get directors' attention, but not so much of a threat that a broad application of *Revlon* will lead to unintended consequences.

The lesson of *Lyondell* is that "an arguably imperfect attempt to carry out Revlon duties" does not equate with "a knowing disregard of one's duties that constitutes bad faith."[176] This sets a high bar for director liability on claims of insufficient effort to maximize value. Plaintiffs must show that target directors "utterly failed to attempt to obtain the best sale price."[177] One would imagine that examples of such behavior would be quite rare.

Absent a showing of bad faith by directors, the best that plaintiffs can hope for is a preliminary injunction that briefly delays the approval of a merger. This gives prospective bidders who might have been shut out by an uninformed and unreasonable deliberative pro-

173 *Thrifty*, 14 A3d at 600 (noting that the two prongs of the *Revlon* inquiry are not considered in isolation from one another).

174 Id at 602.

175 *Lyondell*, 970 A2d at 239–40 (holding that the lower court erred in finding that company directors' had acted in bad faith).

176 Id at 241.

177 Id at 244 (admonishing the lower court for focusing on whether the defendant directors "did everything that they (arguably) should have done to obtain the best sale price").

cess a chance to make a topping bid. This was the case in *In re Del Monte Foods Co Shareholders Litigation*,[178] a recent Court of Chancery case where a board was held to have behaved unreasonably by not giving a conflicted financial adviser sufficient oversight.[179] To obtain an injunction, plaintiffs must demonstrate, among other things, a reasonable probability of success on the merits.[180] In this context, success is broadly construed and does not require a likely finding of money damages against directors.[181]

As these two cases demonstrate, exculpation provisions create a de facto sliding-scale remedy for breaches discovered by *Revlon* enhanced scrutiny. When directors grossly misbehave by evincing a "conscious disregard for [their] duties,"[182] personal liability applies, which is the sort of threat that keeps directors up at night.[183] But when problems are subtler, injunctions are used to delay a deal's consummation. This is inconvenient, somewhat expensive, and makes directors look bad. But, generally speaking, temporary injunctions are only a speed bump whereas personal liability is a brick wall. Directors are much more likely to bend over backwards to avoid the former than the latter. Hence, the rule's nuanced remedies are less likely to make directors favor conservative, low expected value approaches for fear of personal liability.

D. Benefits of the Proposed Framework

There are two major benefits to a wholesale application of enhanced scrutiny to corporate acquisitions. First, it has the effect of reducing doctrinal complexity. From a theoretical perspective, this makes for a more sensible jurisprudence. No longer will the level of judicial scrutiny turn on a distinction without a difference—whether the acquirer paid in cash or stock. From a practical perspective, it should streamline takeover litigation. Just about every deal is challenged in court.[184] A substantial question in most cases is whether en-

178 25 A3d 813 (Del Ch 2011).

179 Id at 836.

180 *Revlon*, 506 A2d at 179.

181 See *Del Monte*, 25 A3d at 836, citing *Macmillan*, 559 A2d at 1284 n 32.

182 *Lyondell*, 970 A3d at 243.

183 Exculpatory clauses may not "eliminate or limit the liability of a director . . . for acts or omissions not in good faith." 8 Del Code Ann § 102(b)(7)(ii).

184 See Cornerstone Research and Robert Daines, *Recent Developments in Shareholder Litigation Involving Mergers and Acquisitions* *2 (2012), online at http://www.cornerstone.com/files/News/d7e418ea-eb2c-4a17-8eae-de2510d9d1ba/Presentation/NewsAttachment/8b664075-ebfb-4cce-aa76-8a050befad03/Cornerstone_Research_Shareholder_MandA_Litigation.pdf (visited Sept 19, 2012) (finding that 96 percent of acquisitions valued at more than $500 million were litigated in 2011, compared to 53 percent in 2007).

hanced scrutiny should apply under *Revlon*. Broad application of enhanced scrutiny would make this unnecessary. This is particularly true in mixed-consideration cases, where the legal rule is fundamentally uncertain. Fewer briefs disputing whether a change of control occurred might reduce litigation costs and move cases toward earlier and more conclusive decisions on the merits.

Applying *Revlon* broadly would not necessarily be a boon for the plaintiffs' bar. At a recent conference, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery argued that a broad application of enhanced scrutiny would have little practical effect on shareholder litigation.[185] According to the Vice Chancellor, what really matters is the ability of another acquirer to make a better offer for the target company.[186] Whether this offer is successful will come down to the defensive measures in place. And these measures will already be subject to enhanced scrutiny under *Unocal*.[187]

The second benefit is to provide a strong judicial backstop supporting target directors in resisting unreasonable requests from aggressive acquirers. The effect is similar to that of *Van Gorkom*, requiring directors to be adequately informed before the protections of the business judgment rule apply.[188] Practically speaking, this means deals involved more lawyers and boards take more time to make merger decisions. Many scholars have criticized *Van Gorkom* for increasing transaction costs without providing additional value to shareholders.[189]

But it is at least possible that requiring companies to slow down and bring in outside advisors in mergers or takeovers will generally increase shareholder value. One set of scholars argued that *Van Gorkom* is a response to the problem of "rush bids": when an acquirer offers to purchase the company at a substantial premium over market price, but only if the target company's board accepts within a few days.[190] A board that turned down such an offer, even by simply asking for more time, could potentially face shareholder liability for

185 Robert E. Spatt, et al, *Developments in M&A Practice Panel* at 40:30, 43d Annual Institute on Securities Regulation (PLI 2011) (Laster speaking) (on file with author).

186 See id at 36:45 ("What people really care about is the ability to top. The ability to top that bid is going to be driven by things like the defensive measures.").

187 See id at 36:55 ("The defensive measures even under the dichotomous view of *Revlon* are subject to *Unocal* review for enhanced scrutiny.").

188 See *Van Gorkom*, 488 A2d at 872–73.

189 See, for example, Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 Bus Law 1437, 1444 (1985).

190 See Jonathan R. Macey and Geoffrey P. Miller, Trans Union *Reconsidered*, 98 Yale L J 127, 136–37 (1988).

failing to sell the company at a favorable price.[191] The strategic acquirer could take advantage of this dilemma by making an offer well above market price but below its reservation price. *Van Gorkom* gives the target board an out; they can take a deep breath while they wait for the now-required investment banker fairness opinion. Similarly, the broad application of *Revlon*'s process-focused enhanced scrutiny rule would allow directors to say "no" to hard-bargaining acquirers without sinking the whole deal. It is much easier to tell someone that you would love to oblige but cannot for fear of getting the deal enjoined than it is to simply say "no."

CONCLUSION

This Comment argues that recent Delaware Court of Chancery decisions make a strong argument for applying *Revlon* enhanced scrutiny to all final-stage transactions. It identifies three factors motivating enhanced scrutiny in the final-stage transaction context. First, the "omnipresent specter"[192] of structural bias—a suspicion that directors about to lose their jobs might let their own interests take precedence over those of shareholders. Second, the "no tomorrow" issue—a takeover is the last chance for a shareholder to have her fiduciary maximize her investment in the target.[193] Whether she receives cash or stock in exchange for her shares, the investment is fundamentally transformed. Third, the last-period problem—the concern that market and reputational incentives will not restrain target directors and officers in their last period of employment.

Applying *Revlon* enhanced scrutiny to these types of transactions has substantial advantages over the current approach. It unifies the legal doctrine applying enhanced scrutiny, which reduces complexity and streamlines litigation. Moreover, it resolves current confusion regarding the status of mixed-consideration deals.

191 This was the very situation that the Trans Union board found themselves in. See *Van Gorkom*, 488 A2d at 868 ("Attorney Brennan advised the members of the board that they might be sued if they failed to accept the offer.").

192 *Unocal*, 493 A2d at 954 (expressing a general concern that the board of a target corporation "may be acting primarily in its own interests").

193 *Smurfit-Stone*, 2011 WL 2028076 at *13.