CORPORATE TAKEOVERS:
A LOOK AT THE CHANGING LAW,
THE FIDUCIARY DUTY OF A CORPORATE DIRECTOR, AND THE BUSINESS JUDGEMENT RULE IN THE CORPORATE TAKEOVER SETTING

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INTRODUCTION

In recent years, corporate takeovers and mergers have been on the increase.[1] As a result, litigation concerning corporate takeovers has also increased.[2] For many years corporate directors' business decisions were largely free from judicial review, as long as the directors used good faith, independence, diligence, and reasonableness in making their decisions.[3] In Zapata Corp. v. Maldonado,[4] the Delaware Supreme Court set as a guideline the court's use of its own independent business judgment when reviewing shareholder derivative actions. Four years later in Unocoal Corp. v. Mesa Petroleum Co.,[5] (Unocoal) the Delaware Supreme Court shifted the burden of proof to corporate directors. In takeover settings, directors must show they had reasonable grounds to believe that a takeover was not in the best interest of the corporation and shareholders.[6]

A few months after Unocoal, the Delaware Court of Chancery decided MacAndrews & Forbes v. Revlon, Inc.[7] (Revlon). The holding in Revlon establishes that corporate directors' primary responsibility in a takeover setting is to the shareholders alone.[8] The Revlon decision sends corporate directors a message that Delaware courts[9] will carefully review decisions made in a takeover setting. Recent decisions before and after Revlon have redefined the

fiduciary duty owed by boards of directors to shareholders in a takeover setting.[10] These decisions have shifted corporate directors' concerns from federal agencies[11] to the judicial system in a takeover setting because the business judgment rule no longer prevents judicial review in a takeover environment. Part I of this note discusses the historical background of a corporate director's fiduciary responsibility and the business judgment rule. Part II analyzes recent decisions addressing a corporate director's fiduciary responsibility to shareholders and the application of the business judgment rule in a takeover setting. Part III considers the effects these recent decisions will have on corporate directors faced with business decisions in a takeover setting.

I. HISTORICAL BACKGROUND OF A CORPORATE DIRECTOR'S FIDUCIARY DUTY AND THE BUSINESS JUDGMENT RULE

A. Origin

The fiduciary responsibilities of corporate directors and the business judgment rule probably originated in England from the evolution of corporations. In 1553 Sebastian Cabot returned to England with news that the Russians were receptive to trade relations with the English.[12] A royal charter was obtained from Bloody Mary by a group of London merchants. It described a corporation "as one bodie and perpetual fellowship and commaltie" known as the "Russia Company."[13] This was the first English Company

intended to operate on a joint stock. The concept of a corporation was possible only by a grant from the crown.[14]

Since corporations were authorized by the crown, a trust responsibility was placed on committeemen.[15] In Charitable Corp. v. Sutton[16] the court stated "by accepting a trust of this sort a committeeman is obliged to execute it with fidelity and reasonable diligence."[17] In Charitable committeeman were held to be agents of the organization.[18] Thus, the fiduciary responsibility of a corporate director evolved from the fiduciary responsibility in agency. The court in Charitable also stated, "that if committeemen execute within their authority and bad consequences occur there is no breach of trust."[19] This statement is related to the modern business judgment rule. The origin of the business judgment rule probably evolved from the origin or use of corporate directors' fiduciary responsibilities.

The word "fiduciary" derives from the civil or Roman Law.[20] It connotes the idea of trust and confidence.[21] The relationship arises whenever the property of one person is placed in the charge of another.[22] Fiduciary responsibilities of corporate directors evolved from the principles of agency from English common law and the principles of Trusts from the Roman civil law.

B. Fiduciary Responsibilities of Corporate Directors and the Business Judgment Rule in the United States

Fiduciary responsibilities of corporate directors and the business judgment rule were used early on in the United States. As the banking industry grew in the United States there became a need for trustworthy persons to be overseers of the banks. Congress established the bank of the United States and enacted as law a requirement that there would be twenty-five directors.[23]

Percy v. Millaudon[24] became the leading authority for the breach of trust standards. The court used the objective test in determining whether bank directors failed to exercise ordinary care in the discharge of their fiduciary duties.[25] The court's rationale is that directors should not be liable for errors of judgment unless it constitutes gross negligence.[26] The United States Supreme Court applied the test from Percy in Briggs v. Spaulding.[27]

The business judgment rule was developed and refined in the latter half of the nineteenth century.[28] Laissez-faire economic and political philosophies began to dominate the industrial revolution of the United States.[29] The idea that freeplay, even selfishness of an individual, were of a benefit to society.[30] Leading proponents of laissez-faire argued that legal control was an economic restraint.[31] This was contrasted with the reality of fraud, cons and ripoffs. The business judgment rule became a compromise, a protection for the good faith shareholders and a necessary evil to the

aspiring businessman seeking capital from prudent investors.[32]

The early cases set a standard of care that has remained intact through the years. The standard of care for directors is not the same as the business judgment rule, they both are often misapplied and misunderstood.[33] The standard of care has been codified by at least twenty states.[34] Section 35 of the Model Business Corporation Act typifies such statutes.[35] The state of Delaware has not codified the standard of care for a corporate director.[36] Delaware, like the majority of states, determines the standard of conduct from case law.[37] In a common law jurisdiction, the nature and extent of a director's fiduciary duty depends upon the circumstances and relationship of the parties in each case.[38]

C. The Relationship Between the Business Judgment Rule and a Corporate Director's Fiduciary Responsibility

The business judgment rule is a dual standard which protects directors from a court's examination of the content of their decision if the directors acted in good faith and exercised due care.[39] Directors owe a fiduciary duty to the shareholders and the corporation to act in good faith and to exercise due care.[40] The business judgment rule historically has provided the presumptions that directors acted in good faith and with reasonable care and that directors exercise sound business judgment.[41] However, a director can

be held liable for acting in bad faith or failing to exercise due care.[42]

In analyzing good faith, the standard is: did the director act for a dishonest purpose?[43] The good faith requirement is met if the director acted with undivided loyalty to the corporation or shareholder.[44] The due care requirement comes from the common law principles of negligence. The due care requirement can be satisfied when directors make a reasonable effort to ascertain and consider all relevant information.[45] A better understanding of the business judgment rule can be obtained by following its use in four separate situations.

The first situation is when a director acts fraudulently. Fraud is acting in bad faith and there is no protection provided by the business judgment rule when bad faith is proven.[46] Bad faith is a breach of a director's fiduciary duty.

A second situation is when the directors are charged with self dealing or putting their own personal interests ahead of the shareholders. The courts will determine whether the self dealing was reasonable based on a rational business purpose.[47]

Courts adopted the reasonable self interest rule over the now extinct void for self dealing rule because the latter rule could obstruct legitimate business activities or the holder of only one share could void a good business decision if a conflict could be shown.[48] In some

jurisdictions the courts will apply a test of fairness. In Delaware the courts will apply the fairness test when the business judgment rule does not apply. In a conflict involving a parent and subsidiary Delaware allows the use of the business judgment rule as a defense minus a showing of gross and palpable overreaching.[49]

Directors cannot make decisions aimed at perpetuating themselves in office. In Delaware the court will apply the primary purpose test. If the court finds that the directors' primary purpose is to cling to control the court can enjoin the directors' actions.[50] If directors act in their own interest the requirement of independence is not met.

A third situation is non feasance. When the directors are charged with negligence because they totally failed to consider a matter, the courts will consider whether the directors exercised reasonable diligence in their failure to act. However, the business judgment rule does not apply when there is no affirmative act of investigation by directors or no decision that business judgment can be claimed.[51]

The final situation is misfeasance. When it appears that directors used reasonable consideration and judgment in making a decision and a bad outcome results, the business judgment rule protects the directors by preventing judicial interference into their decision.[52] However, the business judgment rule will not protect directors when gross negligence is found.[53]

Despite being unclear and confusing these guidelines made the business judgment rule effective. The shareholder was given protection against dishonest directors. The director is allowed discretion to be innovative, even unorthodox, in the corporate business affairs taking risk without the threat of liability. The effect was to promote commerce and judicial economy. The business judgment rule also recognizes human nature that directors are not infallible.[54]

D. The Business Judgment Rule as a Defense

The typical use of the business judgment rule has been in a shareholder derivative action. From Percy v. Maldiraldo[55] until recently courts routinely condoned the use of the business judgment rule by directors.[56]

In Case v. New York Central Railroad Company[57] minority shareholders challenged a parent company's allocation of tax savings that distributed the savings almost exclusively to the parent. The New York Court of Appeals determined that when there is difficulty deciding what is fair, anything short of gross and palpable overreaching does not warrant judicial interference.[58] In a similar case, Getty Oil Co. v. Skelly Oil Co.,[59] Delaware adopted a gross and palpable overreaching standard to warrant judicial review. Delaware reaffirmed its use of gross and palpable overreaching in the landmark case of Sinclair Oil Corp. v. Levien.[60]

In Chasin v. Gluck[61] the Delaware Court of Chancery stated that absent self dealing director defendants charged with responsibility for corporate losses injurious to minority stockholders should not be held accountable unless plaintiff could show that they were guilty of bad faith, negligence, or gross abuse of discretion.[62] The majority of states followed New York and Delaware in regard to shareholder derivative action.[63]

In Zapata Corp. v. Maldonado[64] the business judgment rule was substantially weakened. The Delaware Supreme Court not only considered the traditional good faith, independence, diligence, and reasonableness of directors' decisions but also exercised the courts' own independent business judgment in deciding whether directors' termination of a shareholder derivative action was proper.[65]

E. The Business Judgment Rule in a Takeover Setting: The Early Cases

Courts have held that the business judgment rule was applicable in a takeover environment. In the early cases, directors' actions were usually protected by the business judgment rule.

In Cheff v. Mathes[66] shareholders challenged directors' use of corporate funds to buy out a shareholder who some directors found out informally might pose a threat to the corporation.[67] The court ruled that plaintiff failed to prove that the directors' actions were to perpetuate

themselves in office; thus, the business judgment rule protects the decision.[68]

In Bennet v. Prop[69] a chairman and president spent corporate funds purchasing stock to thwart a takeover without the board's vote.[70] The next day the directors ratified the officers' actions.[71] The shareholders challenged the directors' action and the court ruled that the business judgment rule protected the directors who ratified the illegal action because of the emergency circumstances.[72] The two officers were not protected by the business judgment rule because their action was illegal.[73] The court decided that when a corporation purchases its own stock to fight a takeover, an inherent conflict arises, thus, the burden should shift to directors to justify such a purchase as one primarily in the corporate interest.[74]

In Anderson v. Albert, etc. Mfg. Co.,[75] the court held the use of corporate funds by directors to gain control is a breach of fiduciary duty.[76]

In Gimbel v. Signal Companies Inc.,[78] a stockholder sued to enjoin Signal's sale of a subsidiary for well below market value.[78] The directors had no personal interest and no self dealing was shown. Even with the presumption in favor of the directors and evidence showing the directors acted honestly and in what they believed to be the best interest of the corporation, the court granted a preliminary injunction to study whether the directors acted outside the bounds of reason.[79] The court stated the business judgment

rule does not irrevocably shield decisions of corporate directors from challenge.[80]

The Signal case has facts similar to recent cases discussed later in this note.

In Treadway Companies Inc. v. Care Corp.[81] a director of a target company sold his shares to the acquiring company, then the target sold enough shares to a white knight to prevent a takeover. The court ruled that the director did not breach his fiduciary duty to other shareholders because he was not a majority shareholder.[82] The court ruled that under New Jersey law, directors owe a fiduciary duty to the corporation and indirectly to the shareholders, but not with respect to the shares of stock the directors own.[83] On the issue of the target's issuance of shares to the white knight, the court ruled that such an action was proper and that the business judgment rule was the proper standard because the plaintiff failed to prove self dealing which would have shifted the burden to the directors to prove their actions were fair and reasonable.[84]

In Buffalo Forge Co. v. Ogden Corp.,[85] where the use of the business judgment rule was challenged, the court expressly stated that the business judgment rule is applicable in the context of bidding wars.[86]

II. RECENT DECISIONS ADDRESSING A CORPORATE DIRECTOR'S FIDUCIARY RESPONSIBILITY TO SHAREHOLDERS AND THE APPLICATION OF THE BUSINESS JUDGMENT RULE IN A TAKEOVER SETTING

A. Recent Increase in Takeover Activity

In recent years there has been an increase in takeovers and merges.[87] There are different rationales explaining the increase in takeover activity. One is that a strong corporation should diversify to ride the ups and downs of business cycles.[88] Another is the increased competition from the Japanese necessitates mergers so American companies can compete more effectively.[89] There are others who feel the increase in takeovers is due to the relaxed merger guidelines.[90]

The increase in takeover activity has brought an increase in litigation in the corporate law area to include the duty of directors in a takeover setting.

Litigation occurs because of conflicting interest. When a tender offer is announced it generally is at a premium to what the stock is selling for, allowing stockholders to make a substantial profit.[91] The offeror's price is usually less than the book value of the stock when the assets are valued at current market prices.[92] When directors take actions to prevent takeovers, the shareholders anticipating a profit are unhappy or the acquiring company is unhappy. Litigation has addressed the nature of directors' actions or the validity of corporate directors' defensive measures.

As takeovers increased, the ingenuity of corporate management and directors in creating new defensive measures also increased. Thus, the challenges to these new defenses by shareholders and the acquiring company have increased.

Since 1980 courts have had to decide such defensive measures as the sale of stock to a favored party,[93] the sale of treasury shares to a white knight,[94] the pac-man defense,[95] the disposal of valuable assets,[96] a standstill agreement,[97] sale of discounted subordinate debentures containing springing warrants,[98] refusal to tender shares,[99] amendment to by-laws,[100] and acquisitions to create anti-trust problems.[101]

B. The Recent Cases

Transunion

In Smith v. Van Gorkom[102] (Transunion), a class action suit brought by the shareholders of Trans Union Corporation, the Delaware Supreme Court held the directors personally liable for gross negligence. The defendant directors approved a cash out merger of the company negotiated by the Chairman and Chief Executive Officer Van Gorkom without the board's prior knowledge.[103] In a meeting lasting about two hours, the board made its initial decision based on Van Gorkom's oral presentation and other oral statements.[104] The directors made no inquiry into the adequacy of the $55 per share selling price.[105]

The Court of Chancery allowed the use of the business judgment rule finding that the board met three times to discuss the decision and amended the initial agreement allowing time to test the market as to the fairness of the $55 per share price.[106] The Court of Chancery ruled that the Trans Union board made an informed business decision.

In overturning the trial court, the Delaware Supreme Court reasoned that the business judgment rule is the offspring of the fundamental principle that business affairs of a Delaware Corporation are managed by and under its board of directors.[107] In carrying out this rule, directors are charged with an unyielding fiduciary to the corporation and its shareholders.[108] Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with recognition that he acts on behalf of others.[109]

A director's duty to exercise an informed business decision is in the nature of a duty of care as distinguished from a duty of loyalty.[110] The court stated that the standard of care applicable to a director's duty of care had been restated by this court in Aronson v. Lewis.[111] Under the business judgment rule, director liability is predicated upon concepts of gross negligence. The court reaffirmed the concept of gross negligence as the proper standard.[112]

The determination of whether a business judgment is an informed one turns on whether the directors informed themselves "prior to making a business decision, of all material

information reasonably available to them."[113] The business judgment rule does not protect directors who have made an unintelligent or unadvised judgment.[114] The duty to inform oneself derives from the fiduciary capacity in which he serves the corporation and the shareholders.[115]

Since the Transunion directors made an uninformed decision they were grossly negligent. The directors were unable to use the business judgment rule as a defense because their initial decision was made without proper information at their disposal.[116] Whatever information the directors received after the initial decision and the fact that the stockholders approved the merger did not exonerate the board of gross negligence in reaching its initial decision.[117]

Unocoal

In the recent case of Unocoal Corp. v. Mesa Petroleum Co.[118] (Unocoal), the plaintiff Mesa was a minority shareholder who made a hostile tender offer.[119] The court noted this distinction when applying rules from shareholder derivative cases.[120] The defendants, the board of directors of Unocoal opposed the takeover and made a tender offer for the company's own stock, excluding the raider.[121]

The Delaware Supreme Court expressly allowed the use of business judgment as a defense in fighting a takeover. The court stated that directors have a right and a duty to

protect the corporate enterprise from harm reasonably perceived, irrespective of its source.[122]

The court also held that the directors' decisions to exclude the hostile bidder was not a breach of their fiduciary duty to that shareholder.[123] Due to the nature and circumstances the board had a supervening duty to protect the corporate enterprise and other shareholders.[124]

The court decided the presumption directors enjoyed that business decisions were made on an informed basis and in good faith shifts in a takeover climate.[125] The initial burden now would be on directors to show they had reasonable grounds for believing that a danger existed.[126] The court concluded that for a decision to come within the ambit of the business judgment rule it must be reasonable to the threat posed.[127]

Household

In Moran v. Household International Inc.[128] the Delaware Supreme Court held that the implementation of preventive takeover mechanism, the preferred share purchase rights plan, was a valid use of the business judgment rule.[129] This case is distinguished from those where directors react to a pending takeover bid. Households directors were reacting to a takeover environment.

The plaintiff Moran, one of two directors voting against the measure, had begun discussions concerning a possible leveraged buyout of Household.[130] Moran raised the

issue that the business judgment rule was not the proper standard by which the adoption of the right plan should be reviewed.[131] Moran and the SEC raised the issue that stockholders will lose their right to receive tender offers.[132]

The courting, citing Unocoal, held that the business judgment rule was the proper standard.[133] The court also cited evidence introduced at trial showing many methods around the plan.[134] In citing the Unocoal decision, the court put the initial burden on the directors to show they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed.[135] The directors satisfied that burden by showing good faith and reasonable investigation.

Revlon

Even though the Unocoal and Household decisions were favorable to the directors of the respective companies, the business judgment rule was weakened by the shift of the initial burden to the directors. The cumulative effect of all prior decisions was probably first felt in MacAndrews & Forbes v. Revlon, Inc.[136] (Revlon). The Revlon case not only showed the effect of a weakened business judgment rule, it further weakened it as well as redefining the fiduciary responsibilities of corporate directors in a takeover environment.

In Revlon the acquiror MacAndrews (Pantry) informed Revlon that Pantry was interested in a friendly takeover of Revlon.[137] The price offered was between $40 and $50 per share.[138] The offer was turned down as inadequate and it was disclosed that Revlon was not for sale.[139]

When Revlon's board discussed the Pantry offer, Revlon's investment banker informed the board that Pantry would finance the tender offer with junk bonds, then sell Revlon's divisions separately to make a profit. The banker informed the board that separately Revlon was worth between $60 and $70 per share.[140]

At the same meeting Revlon's special counsel recommended a two-part program to maximize and protect the value of Revlon's shares. The first recommendation was the repurchase of up to 5 million of the nearly 30 million of Revlon's own common stock. The second recommendation was a vote purchase rights plan (poison pill).[141]

In the purchase rights plan Revlon's shareholders would receive a one-vote purchase right as a dividend on each share of common stock. The rights would entitle the holder to exchange one share of common stock for a $65 principal amount of Revlon notes that would pay twelve percent interest, with a one-year maturity.[142] The rights would be triggered when anyone acquired more than 20 percent of Revlon's shares, unless an acquiror consummated a transaction to pay $65 or more in cash. Revlon's board could

redeem the rights for ten cents each at any time prior to the acquisition of 20 percent or more of Revlon's stock.[143]

Revlon's board was advised that if the rights plan were put in place, liquidation of the company would likely follow. Revlon's board unanimously adopted the two-part plan.[144]

Pantry commenced a tender offer for all shares of Revlon's stock at $47.50 per share, conditioned upon Pantry's ability to obtain financing and the Revlon board's recision or redemption of the rights plan.[145]

The Revlon board met and decided to encourage stockholders to take advantage of Revlon's own stock buy back offer. Revlon also expanded its buy back offer from 5 million to 10 million shares.[146]

Revlon proposed to exchange senior subordinated notes and preferred stock for the common stock tendered. The notes contained covenants severely limiting Revlon's ability to incur additional debt, sell assets or pay dividends.[147] The effect of Revlon's offer was a substantial increase in debt and since shareholder equity had been reduced, the value of shares not tendered was reduced.[148]

Pantry countered with a new offer.[149] Unknown to Pantry, Revlon had been negotiating with a white knight to arrange a leveraged buy out.[150] When it became apparent that Pantry would not back off, Revlon's board unanimously agreed to enter into a leverage buyout with Forstman Little (Forstman).[151]

Forstman agreed to assume Revlon's debt and pay $56 per share cash. Revlon waived the covenants on the notes. The notes dropped from $100 to $87 a decline of $60 million below par.[152]

Pantry once again increased its bid.[153] The new offer was conditioned upon Revlon waiving the covenants on the notes as Revlon did for Forstman.[154]

Revlon and Forstman then entered into a new agreement which provided that Forstman would increase its original offer. Forstman was given a "lockup" option to purchase two of Revlon's subsidiaries for $525 million.[155] This option would be triggered whenever anyone acquired forty percent of the outstanding shares. The new merger agreement maintained the rights plan be lifted and the covenants on the notes rescinded.[156] These concessions were not extended to Pantry. Forstman agreed to exchange new notes for all the notes that had dropped in value. Revlon sealed the agreement by placing a $25 million cancellation fee in escrow.[157]

When Revlon's board of directors approved the merger agreement, Pantry filed suit. Pantry sought to prevent the board of Revlon from issuing note purchase rights and to enjoin the lockup option and cancellation fee.

The chancery court enjoined the measures adopted by Revlon's board of directors and the Delaware Supreme Court affirmed.[158] The court held that the business judgment rule may be applied only after the principles of care, loyalty and independence are satisfied.[159]

The court held Revlon's purchase rights plan was a legitimate use of business judgment since the directors had a reasonable fear of a bust up takeover by Pantry.[160] The plan was a reasonable precaution against a bust up takeover. The plan also was a reasonable precaution against an inadequate tender offer. The plan was a factor in raising bids from $42 to $58 per share.[161]

The court held the stock repurchase provision was protected by the business judgment rule also. The board had statutory authority to deal in its own stock and the offer was made in good faith on an informed basis with reasonable grounds to believe that there existed a harmful threat to the corporate enterprise.[162]

The court reasoned that the board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board thus changed from preserving the corporate entity to maximization of the company's value for the benefit of the stockholders.[163]

Since the breakup of the company was a reality, the selective dealing to ward off a hostile bidder was no longer a proper objective. The primary concern of the directors should have been obtaining the highest price for the benefit of the stockholders.[164] When Revlon's directors entered into a lock-up agreement with Forstman they breached their primary duty of loyalty owed to the shareholders.[165] The lockup agreement effectively ended competitive bidding.

Concern for the noteholders was proper, but the primary concern of the directors belonged to the equity owners.[166]

The lockup option was a usurpation of directorial authority and was enjoined since more bidding activity, not less was preferred.[167] The lockup option does not meet the court's own business judgment test standard. Since the cancellation fee was negotiated in the same agreement as the lockup option, it was enjoined also.[168]

C. After Revlon

Smith Corona

The significance of the Revlon decision has yet to be fully felt. One change is that a director's primary responsibility is not to the corporation but to the shareholders. In Hanson Trust PLC v. ML SCM Acquisition Inc.[169] (Smith Corona), a case with facts similar to Revlon, the United States Court of Appeals enjoined the defendant SCM from granting the defendant Merrill Lynch lockup options and cancellation fees.

The case was decided using New York law and the principles outlined in Revlon, which was cited.[170] New York law allows a director a presumption of propriety in analyzing their duty of care.[171] Absent a prima facie showing to the contrary, directors enjoy wide latitude in devising strategies to resist unfriendly takeovers.[172] A distinction in the SCM case from Revlon is that Revlon's directors had the initial burden of proof, but SCM directors enjoyed the

presumption. The appellate court stated "fiduciary duties involve more than avoiding bad faith and self dealing. Directors are held to a standard of due care. They must meet this standard with conscientious fairness.[173] The duty of due care also requires reasonable diligence in protecting a shareholder's welfare. Thus a director's decision must be an informed one."[174] This is where the court found the directors lacking because the SCM board had relied on information supplied to it within two hours. The directors failed to ask key questions. When the investment banker informed them that the lockup option was within the range of fair value, the directors did not ask what fair value was or what the company would be like without the subsidiaries. Nor did they ask, why divisions that generated half of income were being sold for one third of the total purchase price.[175] Directors owe shareholders a duty to become reasonably familiar with an opinion or report before relying on it.[176] In the instant case, time was not of the essence because Hanson's offer would not take effect for three weeks.[177] Another major flaw was the use of a pigment as a unit in assessing the value of an SCM division when it was not a proper measurement.[178]

All of this did not constitute gross negligence under New York law, but the agreement lacked fairness.[179] The fact that the lockup option would end the bidding was the key fact.

Conagra

In a different case, Conagra Inc. v. Cargill Inc.[180] the Nebraska Supreme Court ruled that a corporate board of directors can breach a merger agreement if a better offer comes along before shareholder approval. The rationale was that directors' primary duty is to the shareholders. The plaintiff and defendant corporations were incorporated in Delaware and the Nebraska Supreme Court applied Delaware law.

III. DIRECTORS' FIDUCIARY RESPONSIBILITY AND THE BUSINESS JUDGMENT RULE AFTER RECENT LITIGATION

A. The Changes

Corporate directors' fiduciary duty and the use of their business judgment after Revlon and other recent cases, although weakened, still exist. However, in a takeover setting the scrutiny with which a court will review the directors' decision is different.

In a takeover setting, directors' fiduciary duty is to the shareholder first and then to the corporation.[181] That fiduciary duty to the shareholder is of good faith and diligence.[182] The good faith requirement is satisfied if a director has been loyal to the shareholders. The diligence requirement is satisfied when the director uses due care as an ordinary prudent person in the same or similar circumstances would use.[183] Thus, an informed decision would satisfy the due care requirement.[184]

Directors still enjoy the use of the business judgment rule; however, in Delaware, in a takeover setting, directors have the initial burden of showing that they had a reasonable grounds for fearing the takeover and that their actions were reasonable under the circumstances.[185] In states where directors enjoy a presumption of sound business judgment, they still have to defend their actions if the plaintiff puts on enough evidence to raise a doubt about the fairness of a transaction.[186]

B. The Scope of Judicial Review

When courts address a complaint concerning directors' decisions in a takeover setting, they are likely to go through the check list discussed earlier.

First, the court will look for fraud or bad faith. If there is fraud the business judgment rule will not protect the directors.[187]

Second, they will look for self dealing. If there is self dealing, the courts will analyze whether it was reasonable self dealing.[188] Remember--a director owes a fiduciary duty to shareholders, but, in New Jersey, not to the extent of the shares that the directors personally own.[189] However, directors cannot make a decision in a takeover setting merely to perpetuate themselves in office.[190] Courts will look at what the primary purpose of corporate directors' decisions are.[191] If self dealing was reasonable, then the business judgment rule will protect directors. However, if

the self dealing was not reasonable, directors have no protection from the business judgment rule. Delaware courts, in shareholder derivative actions applies its own business judgment.[192] In other jurisdictions, reasonableness in self dealing is determined by the fact finder.

The third aspect the court will look at is non feasance. The business judgment rule will not offer protection for failure to act if a reasonable man in a same or similar takeover setting would have taken some action.[193] A director has taken an oath to use due care. Due care can be determined to mean taking appropriate action. Because the entire business environment comprises a takeover setting, many companies have taken preventive action to make takeovers more difficult, including staggered directors' terms, poison pill and golden parachutes. The issue of a director's liability for non feasance when no preventive measures are taken and a takeover follows must still be litigated.

Lastly, the court will look at misfeasance to determine if the directors act improperly. In Delaware, the court will use its own business judgment to determine if directors acted improperly. In all jurisdictions, the court will examine transactions to see if they are fundamentally fair.[194] This means that directors cannot recommend approval of a policy that is not in the shareholders' best interest. Directors have a right and a duty to fight a takeover if they find from extensive examination that it is not in the shareholder or corporation's best interest.[195] If the

potential harm is caused by a minority shareholder, directors have the right to exclude those shareholders from remedies the directors approve to cure the potential harm.[196] Directors can also exclude shareholders while buying back only the shares of a raider.[197] However, once a decision to sell the corporation is made, selective dealing is improper. The director's duty is to maximize the price of stock for the shareholders' benefit.

The extent and scope of the corporate directors' examination could determine the availability of the business judgment rule. The one exception might be where the acquiror is a known raider.[198] Otherwise, there is no protection under the business judgment rule if directors fail to ascertain all the facts. Directors' decisions must be informed and they cannot totally rely on experts. If the decision is not informed, directors could be liable for gross negligence.[199]

Courts, when applying their own business judgment, will look at the content and analysis of a decision. Some of the factors the courts will consider are: the number of independent outside directors on the board; the amount of time the board had to study proposals before reaching a decision; the changes in monetary values of common stock after directors' decisions; and the minutes of the board of directors for evidence that directors asked pertinent questions.[200]

Generally, directors will enjoy the protection of the business judgment rule in a misfeasance action if they show

they acted in good faith and loyalty to the shareholder and their decisions are informed, fair as to the shareholders, and reasonable.[201]

CONCLUSION

Corporate directors' fiduciary duties have remained largely the same. The major difference is the primary duty to the shareholder. The application of the business judgment rule remains largely the same. However, in a takeover setting, courts are no longer reluctant to examine directors' decision making processes. Thus, the business judgment rule does not offer blanket protection. A comparison of the business judgment rule before and after recent decisions cannot be ascertained due to differing environments. Unknown is the effect of the recent rulings. Will the rulings offer shareholders protection from bad decisions, ensuring that directors will adhere to diligent standards? Or will the recent rulings prove an unreasonable obstacle or distraction to directors in carrying out their corporate duties? Myles L. Mace, in his book Directors: Myth and Reality describes directors as successful persons selected for their status in society, with little time to devote to the corporation for which they serve. The recent litigation might have an effect on who becomes directors. In a takeover setting shareholders appear to be the winners.

ENDNOTES

1. Main, Companies That Float From Owner to Owner, Fortune, April 26, 1986, at 34; Saul, Hostile Takeovers: What Should Be Done?, Harv. Bus. Rev., Sept.-Oct. 1985 at 18.

2. Wash. Post, Jan. 26, 1986, at F1, col. 2; see also Delaware's Grand Masters of the Merger Game, Bus. Wk. Feb. 3, 1986, at 90.

3. Block & Prussin, The Business Judgement Rule and Shareholder Derivative Actions: Viva Zapata?, 37 Bus. Law 27, 29, 33 (1981).

4. 430 A.2d 779 (Del. 1981).

5. 493 A.2d 946 (Del. 1985).

6. Id. at 954-55.

7. 501 A.2d 1239 (Del. Ch. 1985), aff'd, 505 A.2d 454 (1985), 506 A.2d 173 (Del. 1986). The Delaware Supreme Court heard the appeal on an expedited basis in light of a pending Pantry Pride offer. The appeal was accepted on Oct. 25, 1985. The briefs were filed Oct. 28 and 29, 1985. Oral arguments were heard Oct. 31, 1985. The Delaware Supreme Court affirmed in an oral ruling on Nov. 1, 1985, and the written opinion followed on Mar. 13, 1986.

8. 506 A.2d 173, 186 (Del. 1986).

9. This note discusses cases generally from various jurisdictions with an emphasis on Delaware decisions.

10. See, e.g., Moran v. Household Int'l, 500 A.2d 1346 (Del. 1985), before Revlon; Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986), after Revlon.

11. The federal agencies that corporate directors are concerned with in a takeover setting, the Securities and Exchange Commission (SEC) and the Federal Trade Commission (FTC). The SEC polices possible securities violations. See, e.g., Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981). The FTC functions include anti-trust with regard to corporate mergers. See, e.g., Marathon Oil Co. v. Mobil, 669 F.2d 378 (6th Cir. 1981). See also Brown Shoe Co. v. United States, 370 U.S. 294 (1962).

12. Votaw, The Politics of a Changing Corporate Society, Cal. Mgmt. Rev. Spring 1960, at 106.

13. Id.

14. Id.

15. Id.

16. 2 Atk. 400 (1742).

17. Id. at 406.

18. Id.

19. Id.

20. 1 Bouvier's Law Dictionary 1216 (8th ed. 1914).

21. Hamby v. St. Paul Mercury Indem. Co., 217 F.2d 78, 80 (4th Cir. 1954).

22. Id. at 80.

23. Act of Feb. 25, 1791, 1 Stat. 191, 192.

24. 8 Mart. (n.s.) 68 (La. 1829).

25. Id. at 77-78.

26. See also Hodges v. New England Screw Co., 1 R.I. 312 (1850); Godbold v. Branch Bank, 11 Ala. 191 (1847).

27. 141 U.S. 132 (1891).

28. For a complete discussion of the business judgment rule, see Arsht, The Business Judgment Rule Revisited 8 Hofstra L. Rev. 93 (1979).

29. See C. Wright, Economic History of the United States (1941).

30. See Adam Smith, The Wealth of Nations 321, 325-26 (1776).

31. Id.

32. Arsht, supra note 28, at 97.

33. Id. at 101.

34. See Veasey & Manning, Codified Standard--Safe Harbor or Unchartered Reef?, 35 Bus. Law. 919, 921 n.4 (1980).

35. Section 35 states: "A director shall perform his duties as a director . . . in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent

person in a like position would use under similar circumstances . . . ."

36. Delaware's position is important because in 1979, 40% of the corporations listed on the New York Stock Exchange and approximately 48% of the corporations appearing on the "Fortune 500" list were Delaware corporations. Veasey and Manning, supra note 34, at 921 n.6.

37. See, e.g., Meyerson v. El Paso Natural Gas Co., 246 A.2d 789, (Del. Ch. 1967).

38. Id. at 790.

39. See, Arsht, supra note 28, at 95.

40. See generally, Lewis, The Business Judgement Rule and Corporate Directors' Liability for Mismanagement, 22 Baylor L. Rev. 157 (1970).

41. Id.

42. See, e.g., Chasin v. Gluck, 188 A.2d 192 (Del. Ch. 1971); Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969).

43. See, e.g., Security Trust Co. v. Dabney, 372 S.W.2d 401, 406 (Ky. 1963).

44. See, e.g., Auerbach v. Bennett, 47 N.Y.2d 619, 629, 393 N.E.2d 994, 999, 419 N.Y.S.2d 920, 926 (1979).

45. See, e.g., Thomas v. Kempner, 398 A.2d 320, 323-24 (Del. Ch. 1979).

46. Gall v. Exxon Corp., 418 F. Supp. 508, 516 (S.D.N.Y. 1976).

47. See, e.g., Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969).

48. See, e.g., Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980).

49. Gimbel v. Signal Companies, Inc., 316 A.2d 599 (Del. Ch.), aff'd per curiam, 316 A.2d 691 (Del. 1974). For a discussion see Arsht, supra note 28, at 104.

50. See, e.g., Bennett v. Propp, 187 A.2d 405, 408 (Del. 1962).

51. Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. N.Y. 1944).

52. See, e.g., Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).

53. Smith v. Van Gorkom, 488 A.2d 858, 874-78 & n.19 (Del. App. 1985).

54. See generally Comment, The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint, Geo. Wash. L. Rev. 562, 564 (1967).

55. 8 Mart. (n.5) 68 (La. 1829).

56. See also Bodell v. General Gas & Electric Corp., 15 Del. Ch. 420, 140 A. 264 (1927).

57. Case v. New York Central R.R. Co., 15 N.Y.2d 150, 256 N.Y.S.2d 607, 204 N.E.2d 643 (1965).

58. Id. at 157, 256 N.Y.S.2d at 611, 204 N.E.2d at 646.

59. 267 A.2d 883 (Del. 1970).

60. 280 A.2d 717, 720 (Del. 1971).

61. 282 A.2d 188 (Del. Ch. 1971).

62. Id. at 192-93.

63. Arsht, supra note 28, at 100.

64. 430 A.2d 779 (Del. 1981).

65. See Block & Prussin, The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?, 37 Bus. Law. 27 (1981).

66. Cheff v. Mathes, 199 A.2d 548 (Del. 1964).

67. Id. at 551.

68. Id. at 556.

69. 187 A.2d 405 (Del. 1962).

70. Id. at 407.

71. Id.

72. Id. at 410.

73. Id. at 411.

74. Id. at 409.

75. 325 Mass. 343, 90 N.E.2d 541 (1950).

76. Id. at 346, 90 N.E.2d at 543.

77. 316 A.2d 599 (Del. Ch. 1973), aff'd per curiam, 316 A.2d 619 (Del. 1974).

78. Id. at 601.

79. Id. at 616-18.

80. Id. at 609.

81. 638 F.2d 357 (2d Cir. 1980).

82. Id. at 375-76.

83. Id. at 375.

84. Id. at 383.

85. 717 F.2d 757 (2d Cir. 1983), cert. denied, 464 U.S. 1018 (1983).

86. Id. at 759.

87. See generally A. Michel & I. Shaked, Takeover Madness--Corporate America Fights Back (1986).

88. Jensen, Takeovers: Folklore and Science, 62 Harv. Bus. Rev. 109-10 (1984).

89. Id. at 110.

90. See U.S. Department of Justice, Merger Guidelines §§ I-V (June 14, 1982) (the merger guidelines were revised in June, 1984).

91. Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981).

92. Id. at 1163.

93. See, e.g., Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980).

94. See, e.g., Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757 (2d Cir. 1983), cert. denied, 464 U.S. 1018 (1983).

95. See, e.g., Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623 (D. Md. 1982).

96. See, e.g., Whittaker Corp. v. Edgar, 535 F. Supp. 933 (N.D. Ill. 1982).

97. See, e.g., Enterra Corp. v. SAS Associates, 600 F. Supp. 678 (E.D. Pa. 1985).

98. See, e.g., Gearhart Indus., Inc. v. Smith Intn'l, 741 F.2d 707 (5th Cir. 1984).

99. See, e.g., Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981).

100. See, e.g., Treco, Inc. v. Land of Lincoln Sav. & Loan, 749 F.2d 374 (7th Cir. 1984).

101. See, e.g., Panter v. Marshall Field, 646 F.2d 271 (7th Cir. 1981). For a discussion of defensive tactics see Easterbrook & Fischel, Takeover Bids, Defensive Tactics, and Shareholders' Welfare, 36 Bus. Law. 1733 (1981).

102. 488 A.2d 858 (Del. 1985).

103. Id. at 869.

104. Id.

105. Id.

106. Id. at 870.

107. Id. at 872.

108. Id.

109. Id.

110. Id. at 872-73.

111. 473 A.2d 805, 812 (Del. 1984).

112. 488 A.2d 858, 873.

113. Id. at 874.

114. Id.

115. Id. at 872.

116. Id. at 875.

117. Id.

118. 493 A.2d 946 (Del. 1985).

119. Id. at 949.

120. Id.

121. Id. at 950.

122. Id. at 958.

123. Id.

124. Id.

125. Id. at 954-55. The decision expands on the holding of Bennett v. Propp, 187 A.2d 405, 409 (1962). In Bennett the court shifted the burden of proof to directors where there was an inherent conflict such as the purchase of shares with corporate funds. In Unocal the burden of proof was shifted generally in a takeover setting.

126. Id. at 955.

127. Id.

128. 500 A.2d 1346 (Del. 1985).

129. Id. at 1350.

130. Id. at 1349.

131. Id. at 1350.

132. Id. at 1354. The SEC filed an amici curiae brief.

133. Id.

134. Id.

135. Id.

136. 506 A.2d 173 (Del. 1986).

137. Id. at 176.

138. Id.

139. Id.

140. Id. at 177.

141. Id.

142. Id.

143. Id.

144. Id.

145. Id.

146. Id.

147. Id.

148. Id.

149. Id.

150. Id. In Starkman v. Marathon Oil Co., 772 F.2d 231 (6th Cir. 1985), the U.S. Court of Appeals held there was no duty to disclose preliminary merger discussions and failure to disclose preliminary merger discussions does not violate SEC Rule 10b-5.

151. Id. at 178.

152. Id.

153. Id.

154. Id.

155. Id. at 179.

156. Id.

157. Id.

158. Id.

159. Id.

160. Id. at 180-81.

161. Id. at 181.

162. Id. The statutory authority is Del. Code Ann. tit. 8, §§ 122(13) & 141 (1974).

163. Id. at 182.

164. Id.

165. Id. at 184. For a discussion of lock-up options see Note, Lock-Up Options: Toward a State Law Standard, 96 Harv. L. Rev. 1068 (1983).

166. Id. at 182-83.

167. Id. at 184.

168. Id.

169. 781 F.2d 264 (2d Cir. 1986).

170. Id. at 274.

171. Id.at 273.

172. Id.

173. Id. at 274.

174. Id.

175. Id. at 275.

176. Id.

177. Id.

178. Id. at 279.

179. Id. at 275.

180. 222 Neb. 136, 382 N.W.2d 576 (1986). But see Texaco, Inc. v. Pennzoil Co., 784 F.2d 1133 (2d Cir. 1986) when a third party interferes with a merger agreement.

181. Revlon, Inc. v. McAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).

182. Lewis, The Business Judgment Rule and Corporate Directors' Liability for Mismanagement, 22 Baylor L. Rev. 157, 161 (1970).

183. Id. at 162.

184. Id. at 162-63.

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

186. Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986).

187. Chasin v. Gluck, 188 A.2d 192 (Del. Ch. 1971).

188. See, e.g., Diamond v. Oreamuno, 24 N.Y.2d 499, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969).

189. See Treadway Cos., Inc. v. Care Corp., 638 F.2d 357, 375 (2d Cir. 1980).

190. See, e.g., Bennett v. Propp, 187 A.2d 405, 408 (Del. 1962).

191. Id.

192. See Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

193. See Kaplan v. Centex Corp., 284 A.2d 199 (Del. Ch. 1971).

194. See, e.g., Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986).

195. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

196. Id. at 955-56.

197. Pogostin v. Rice, 480 A.2d 619 (Del. 1984).

198. Unocal, 493 A.2d at 956.

199. See Smith v. Van Corkum, 488 A.2d 858 (Del. 1985).

200. Revlon, 506 A.2d at 183.

201. See generally Unocal, 493 A.2d at 946; Revlon, 506 A.2d at 173.