The Legitimacy of Defensive Tactics in Hostile Takeovers under Texas Law

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I. Introduction

A. The Basic Scenario

1. A bidder makes a tender offer at a substantial premium for the stock of a publicly traded target company. Historically, these premiums have averaged 50% above market.

2. The target company's board determines to reject the bid on the grounds that it is financially inadequate.

3. To impede the bidder's offer, the target company adopts defensive tactics. For example, the board might adopt a "flip in" poison pill plan. Pursuant to such a plan, the board issues rights to its common stockholders that are activated by purchases above some threshold, usually 10% or 15%. If a bidder crosses this threshold, all of the target company's shareholders, other than the bidder, have the right to purchase the target company's stock at half price. Prior to the time the relevant threshold is crossed, the target's board may redeem the rights for a nominal price. The poison pill essentially gives the target's board a veto over the offer. If it leaves the rights in place, the economic dilution that the bidder would suffer makes the tender offer undesirable to consummate.

4. The basic legal question: How should the courts review the decision of the target company's board to adopt defensive tactics like the poison pill?

5. Efficient market theorists have long argued that premium tender offers create value for society and that, therefore, a target company's board should remain passive in the face of such an offer. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165-82 (1981). This rule that defensive tactics are per se invalid has never been adopted by the courts.

B. Traditional Modes of Judicial Review

1. Outside the takeover defense context, board decisions are reviewed according to one of two standards: the business judgment rule or the entire fairness test.

2. The business judgment rule applies whenever a disinterested board makes a decision after conducting an adequate investigation. In this context, a court will uphold a board decision if the board's decision can be attributed to any rational purpose. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). The board does not have to prove that the relevant business decision was beneficial to the corporation. It does not even have to prove that it took the decision for the articulated purpose. The board only has to articulate a rational business purpose for its actions. The business judgment rule is a rule of directors' carte blanche.

3. Where a majority of the directors have a conflict of interest in making some decision, that decision will be reviewed according to the entire fairness test. Pursuant to this test, the board must prove "fair dealing" and "fair price." That is, the board must prove that its procedures were fair and that its business decision was justified on the substantive business merits. *See, e.g.*, Kahn v. Tremont Corp., 694 A.2d 422, 430 (Del. 1997).

4. Prior to 1985, most courts evaluated defensive tactics according to the traditional framework. If a majority of the target company's board consisted of independent, outside directors, and the board made an adequate investigation prior to adopting defensive tactics, most courts applied the business judgment rule to determine the validity of defensive tactics. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 293-94 (7th Cir.), cert. denied, 454 U.S. 1092 (1981). Not surprisingly, defensive tactics were almost universally upheld under this deferential standard of judicial review.

5. Prior to 1985, the Delaware courts purported to apply a "primary purpose" test to determine the validity of defensive tactics. *See, e.g.*, Cheff v. Mathes, 199 A.2d 548, 554 (Del. 1964). Pursuant to this test, the courts asked whether the primary purpose of a target company's board was to further legitimate business interests or to perpetuate its control. Despite the different phraseology, the Delaware courts usually accepted the board's proffered purpose and did little to investigate whether that purpose was primary. As a consequence, in practice the Delaware "primary purpose" test was indistinguishable from the business judgment rule.

II. The *Unocal* Standard

A. The Promulgation of an Intermediate Standard of Judicial Review

1. The Delaware courts became concerned that the primary purpose test and the business judgment were too deferential. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (noting that, in the takeover defense context, there is an "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders").

2. The Delaware courts were aware that the entire fairness test is usually also outcome determinative. *See, e.g.*, AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986). In the context of defensive tactics, this test would require the target company's board to prove that a premium tender offer is inadequate as a substantive business matter. Such proof would presumably be difficult to establish in most cases.

3. As a consequence, the Delaware Supreme Court adopted a mode of judicial review for defensive tactics that it viewed as intermediate between the business judgment rule and the entire fairness test. According to Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985), in adopting defensive tactics a target company's board must prove that it has "reasonable grounds for believing that a danger to corporate policy and effectiveness exist[s]" and that such tactics are "reasonable in relation to the threat posed." *Id.* at 955.

B. The Operation of the Unocal Standard

1. A Taxonomy of Threats

a. Inadequacy as to Price

i. The Delaware courts have squarely held that a target company' s board may rely on the financial inadequacy of a premium tender offer to justify defensive tactics. *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 n.12 (Del. 1989); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1342 (Del. 1987); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 n.10 (Del. 1985).

ii. The Delaware courts have been generous in accepting proof of inadequacy. They have allowed the board to rely on an investment banker's inadequacy opinion and declined to examine whether the board or the banker had any reasonable basis for its substantive conclusions. *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1383-85 (Del. 1995); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1339 n.12 (Del. 1987); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 177, 181 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 950, 956 (Del. 1985). The Delaware courts have also been lenient in accepting proof of inadequacy by permitting directors to compare the target company's liquidation value to the bid price in cases in which the directors were not considering liquidation as an option. *See Newmont*, 535 A.2d at 1339; *Revlon*, 506 A.2d at 176-77; *Unocal,* 493 A.2d at 950-51. In such cases, the appropriate benchmark would seem to be the target company's going concern value because this value is the one shareholders will receive if the bid is defeated.

b. Coercion: The courts have roundly condemned coercive partial and two-tiered tender offers (*i.e.,* a partial offer combined with an announced plan to follow up with a squeezeout merger, usually at a lower price or for different consideration than the original offer). *See* Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 630 (D. Md. 1982); Radol v. Thomas, 534 F. Supp. 1302, 1311-12 (S.D. Ohio 1982); Gilbert v. El Paso Co., 575 A.2d 1131, 1135 n.7 (Del. 1990); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1342 (Del. 1987); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1357 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 (Del. 1985). Partial and two-tiered tender offers are coercive because, if the bidder purchases less than all of the shares in a tender offer , the remaining shares are usually worth less than the tender offer price. As a consequence, there is significant pressure on shareholders to tender even if they view the bid as less than adequate.

c. Greenmail: In *Unocal* itself, the Delaware Supreme Court held that a bidder's reputation as a greenmailer (*i.e.*, someone who had previously withdrawn takeover bids and sold stock back to target companies at a profit) justified defensive tactics. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 (Del. 1985). Greenmail is allowed under Delaware law because a bidder may pursue conduct that harms a target company's shareholders (*e.g.,* by making a coercive two-tiered tender offer or by proposing to sell significant assets after completing a partial offer and acquiring

control). However, one would have thought that in these circumstances the substantively harmful conduct threatened by the bidder would be used to justify defensive tactics rather than the threat of greenmail.

d. **Disrupting the Target Company's Business Plan**: In Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989), the Delaware Supreme Court held that the target company could defend against an offer that was a "threat" to a plan of merger that had been in the works for a substantial period of time. The court specifically noted that the target company's board was not required to compare the potential value of the merger with the price of a hostile tender offer: "The open-ended analysis mandated by *Unocal* is not intended to lead to a simple mathematical exercise; that is, of comparing the discounted value of [the merged company's] expected trading price at some future date with [the bidder's] offer and determining which is the higher." *Id.* at 1153. If a board can defend against a tender offer to advance its business plan without regard to the comparative value of any outstanding bid, there would appear to be no restrictions on tender offer defense because most companies have a multi-year business plan and almost every unsolicited offer represents a diversion from that plan. Perhaps *Time*—which involved an extraordinary transaction of many years planning—is limited to its facts.

e. **Threats to Non-Shareholder Constituencies**: The *Unocal* court explicitly empowered a target company's board to consider "the impact on 'constituencies' other than shareholders (*i.e.*, creditors, customers, employees, and perhaps even the community generally)." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985). This approach may be criticized on two grounds: (a) it is theoretically questionable whether the board should be allowed to benefit non-shareholder constituencies without a nexus to shareholder value; and (b) the benefit to such constituencies may be used as a pretext to allow a target company's board to perpetuate its control at the expense of shareholders. Nevertheless, I have argued in support of this branch of the Delaware Supreme Court's jurisprudence. *See* Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: Bridging the Unocal/Revlon Gap*, 35 Ariz. L. Rev. 989, 1022-35 (1993).

2. Proportionality

a. The Delaware courts have been lenient in accepting proof of proportionality.

b. Where inadequacy is the perceived threat, the Delaware courts have allowed target companies to preclude offers and have not required the target company's board to negotiate with the bidder, conduct an auction, or determine whether an adequate offer can be procured. *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1142 (Del. 1989); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1285 n.35 (Del. 1988); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344-45 (Del. 1987).

c. Where coercion is the articulated threat, the Delaware courts have not limited defensive action to removing the coercive aspects of the offer. For example, in *Unocal* the target company's board faced an offer to purchase half the company for $54 per share in cash and half for securities the bidder valued at $54 per share. Because the second-step securities were of questionable value,

the offer in Unocal was a coercive, two-tiered offer. In response, Unocal's board announced a $72 self-tender for up to 49% of the company's stock, an action the Delaware Supreme Court validated based in part on the coercive nature of the original offer. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 956 (Del. 1985). However, removing the coercive aspects of the original offer required nothing more than guaranteeing non-tendering shareholders a present value of $54 per share.

d. To the extent that Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989), allows defensive tactics because a takeover bid threatens to disrupt a target company's business plan, precluding such an offer would seem proportional by definition.

e. The proportionality of defensive tactics justified by the threat of greenmail or the threat to non-shareholder constituencies has not been addressed by the Delaware courts as an independent matter. The cases that involved such threats also involved other threats (*e.g.,* price inadequacy, coercion, disruption of the target's business plan) that justified defensive tactics.

3. Conclusion: Like the primary purpose test, the *Unocal* standard appears indistinguishable from the business judgment rule.

III. The Revlon Standard

A. Judicial Review in the Sale Context: Once target company directors decide to sell their company instead of simply warding off a potential acquiror, a different framework of judicial review applies. In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985), the Delaware Supreme Court held that, in the sale context, target company directors are required to attempt to maximize shareholder value. *See id.* at 182.

B. Attempting to Maximize Shareholder Value

1. **The Duty of Care:** *Revlon's* requirement that directors have a reasonable basis for ascertaining the company's value in the sale context is to some extent an application of the duty of care. Although the board is not required to conduct an auction, it is required to have some reasonable basis for the conclusion that its actions are likely to be value maximizing. The courts have permitted directors to rely on traditional financial analyses, *see, e.g.*, In re Vitalink Communications Corp. Shareholders Litig., [1991-92] Fed. Sec. L. Rep. (CCH) ¶ 96,585, at 92,740-43 (Del. Ch. 1991); Roberts v. Gen. Instrument Corp., [1990] Fed. Sec. L. Rep. (CCH) ¶ 95,465, at 97,403-05 (Del. Ch. 1990), and market test procedures, *see, e.g.*, Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286-87 (Del. 1989); In re Fort Howard Corp. Shareholders Litig., 1988 WL 83147, at *13 (Del. Ch. 1988), to satisfy their duty to attempt to maximize shareholder value.

2. **Bidder Favoritism:** The Delaware courts have been suspicious of white knight transactions in which a target company's board grants items of favoritism to its preferred suitor. Examples of such favoritism include no shop clauses (a prohibition against seeking additional bidders or sharing information with other bidders), bust up fees (a monetary consolation prize to the favored bidder if

some other bidder wins the contest), and lock-up options (allowing a favored bidder an option to purchase stock or assets of the target company, usually at bargain prices). The Delaware courts have routinely proscribed bidder favoritism that was not necessary to generate a bidding contest and that resulted in only a small increase in the highest offer. *See* Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34, 49-50 (Del. 1993); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1284-86 (Del. 1988); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 183-84 (Del. 1985). Such favoritism essentially ends a bidding contest with no benefit to shareholders.

3. Conclusion: Once the *Revlon* standard of review is triggered, two things change dramatically: (a) the standard of judicial review of defensive tactics is considerably less deferential than that employed under *Unocal;* and (b) non-shareholder constituencies may no longer be considered.

4. Which Transactions trigger Revlon?

a. Selling Control: Selling control of a target company triggers the *Revlon* standard of review. *See* Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del. 1993). Two factors justify imposing the duty to attempt to maximize shareholder value on the target company's board: (a) the minority shareholders will be subject to the power of a new controlling shareholder; and (b) the minority shareholders will no longer have the ability to sell their shares at a premium absent the consent of the new controlling shareholder.

b. Mergers of Equals: The courts have not imposed *Revlon* duties in the aftermath of stock-for-stock mergers between two large companies where post-merger control rests in the hands of an unaffiliated body of public stockholders rather than in the hands of a single stockholder or group. *See* Arnold v. Soc'y for Sav. Bancorp. Inc., 650 A.2d 1270, 1290 & n.44 (Del. 1994); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 46-47 (Del. 1989).

c. Tender Offers: The mere fact that a tender offer is made for a target company does not trigger the Revlon standard of review. *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1151 (Del. 1989).

d. Restructurings: In City Capital Assocs. Ltd. Partnership v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988), the Delaware Chancery Court held that a substantial restructuring, which involved borrowing money, selling assets, and paying a dividend to shareholders equal to over 85% of the target company's value, did not trigger *Revlon*. *See id.* at 801-03. This holding is questionable in light of pronouncements by the Delaware Supreme Court that Revlon is triggered where a target company "abandons its long-term strategy and seeks an alternative transaction . . . involving the breakup of the company." Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989).

IV. Texas Law

A Gearhart: The leading case on the legitimacy of defensive tactics under Texas law is the Fifth Circuit's opinion in Gearhart Industries, Inc. v. Smith International, Inc., 741 F.2d 707 (5th Cir. 1984). Like most pre-*Unocal* cases, *Gearhart* applied the business judgment rule to determine the validity of defensive tactics. *See id.* at 722-24. The interesting question is whether *Gearhart* survives *Unocal*, *Revlon*, and their progeny.

B. Copeland: The difficulty in predicting the extent to which Texas courts will depart from the traditional law surveyed in *Gearhart* is illustrated by A. Copeland Enterprises, Inc. v. Guste, 706 F.Supp. 1283 (W.D. Tex. 1989). In *Copeland*, the court was faced with a target company's adoption of a "flip-in" poison pill plan and its use to impede a hostile tender offer so that the board could conduct an auction. The court initially suggested that it would follow *Gearhart*. *See id.* at 1289. However, large portions of the *Copeland* opinion are in reality the application of Delaware law. The court specifically considered and applied *Revlon* duties in the sale context. Had the court been truly applying *Gearhart*, it would have adopted a business judgment rule analysis that would have made the legitimacy of the board's defensive tactics a foregone conclusion.

C. The Business Organizations Code: The Business Organizations Code contains a suggestion that the Texas courts should be relatively lenient in addressing defensive tactics in the takeover context. Section 21.401 of the Code provides:

> In discharging the duties of director under this code or otherwise and in considering the best interests of the corporation, a director may consider the long-term and short-term interests of the corporation and the shareholders of the corporation, including the possibility that those interests may be best served by the continued independence of the corporation.

TEX. BUS. ORGS. CODE ANN. § 21.401(b).

This statute had its genesis as part of the Business Combination Law (which places a three-year moratorium on business combinations with a 20% shareholder unless approved by the target company's board prior to acquisition of the 20% interest or by a two-thirds vote of disinterested shares). *See* TEX. BUS. ORGS. CODE ANN. § 21.601 et seq. The Texas Business Corporation Act's version of the Business Combination Law appeared at TEX. BUS. CORP. ACT ANN., art. 13.01 et seq. (expired). In deciding whether to allow a business combination with a 20% shareholder, the TBCA permitted a board to consider the interests now specified in Section 21.401. *See* TEX. BUS. CORP. ACT ANN., art. 13.06A (expired).

The Business Organizations Code was intended as a codification of Texas' business statutes. In general, it did not effect substantive changes. There were, nevertheless, a number of subtle substantive changes. The statute defining the interests that a board may consider now appears in the section of the Code that deals with the general duties of directors. It is no longer limited to decisions made pursuant to the Business Combination Law. As a consequence, the statute may suggest that the business judgment rule should apply to the legitimacy of defensive tactics in Texas. At the very least, this statute codifies the view exemplified by *Unocal* and its progeny that a target company's

directors are under no duty to sell the company in response to a premium offer and may undertake defensive tactics in response to such offers.

D. Other Jurisdictions: Delaware takeover law has been influential across the nation. *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 253 (7th Cir. 1986) (noting that "Indiana takes its cues in matters of corporation law from the Delaware courts"), rev'd on other grounds, 481 U.S. 69 (1987); Amanda Acquisition Corp. v. Universal Foods Corp., 708 F.Supp. 984, 1009 (E.D. Wis.) (predicting that "a Wisconsin court would apply the *Unocal* standard for reviewing a board's actions in connection with a hostile takeover offer"), aff'd on other grounds, 877 F.2d 496 (7th Cir.), cert. denied, 493 U.S. 955 (1989). However, its adoption has not been unanimous. Pennsylvania and Ohio have, for example, passed statutes mandating a business judgment rule approach to takeover defense decisions. *See* 15 PA. CONS. STAT. ANN. § 1715(D); OHIO REV. CODE ANN. § 1701.59(C)(1)(a); *see also* Shenker v. Laureate Educ., Inc., 983 A.2d 408 (Md. 2009) (holding that a Maryland statute providing that "[a]n act of a director relating to or affecting an acquisition or a potential acquisition of control of a corporation may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director" indicated the Maryland legislature's rejection of *Unocal* and its progeny). Moreover, *Revlon's* proscription against considering the interests of non-shareholder constituencies in the sale context has been overruled by statute in a majority of states. *See* John H. Matheson & Brent A. Olson, *Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation*, 59 GEO. WASH. L. REV. 1425, 1540-44 (1991) (summarizing 29 non-shareholder constituency statutes).

E. The Texas Supreme Court's Choices

1. The Texas Supreme Court may ultimately choose to follow *Unocal* and *Revlon* because these decisions represent sound policy and represent something of a majority rule.

2. The Texas Supreme Court may choose to adopt the pre-*Unocal* view that the business jugment rule protects defensive tactics adopted by a board composed of a majority of independent, outside directors acting with due care. This is generally the view taken by the states that reject Delaware law.

3. The Texas Supreme Court may choose to require that, after an appropriate period to negotiate and develop alternatives, a target company's board must step aside and allow shareholders to assess the viability of an offer. As noted above, this view is espoused by academics who believe in the efficient market hypothesis. It was also once espoused by the Delaware Chancery Court in City Capital Assocs. v. Interco, Inc., 551 A.2d 787, 798-801 (Del. Ch. 1988). It should be noted, however, that the *Interco* decision was later disavowed by the Delaware Surpreme Court. *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1152-53 (Del. 1989).