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Change of Control Board: Federal Preemption of the Law Governing a Target's Directors

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CHANGE OF CONTROL BOARD: FEDERAL PREEMPTION OF THE LAW GOVERNING A TARGET’S DIRECTORS

ABSTRACT

This article sets out a proposed federal uniform standard governing the actions by the board of directors of a publicly held corporation that is the target of a change of control transaction. This proposal would apply in each of the following four merger and acquisition transactions: (1) the acquisition of a target in an arm’s-length negotiated merger or acquisition; (2) the acquisition of a target in a management buyout; (3) the proposed acquisition of a target in a hostile tender offer; and (4) the acquisition by a target’s controlling shareholder of the minority interests in such target in a freezeout merger.

Under this proposal, an independent and knowledgeable change of control board would be appointed for the target, and this board would have complete authority over the acquisition process. Because of the board’s obvious independence, a uniform governance standard, the business judgment rule, would apply in determining if the board acted properly.

This article proposes that federal law preempt state law rules governing the actions of a publicly held target’s board in each of these transactions. However, this is only a default rule because a corporation’s shareholders could elect not to have the provision apply or could elect to have it apply only in certain circumstances, such as in a hostile tender offer. The adoption of this provision would enhance the competition for corporate governance rules in change of control transactions.

This proposal would replace the four separate governance rules generally applicable to a target’s directors under Delaware and other state law in arm’s-length transactions, management buyouts, tender offers, and freezeouts. This article
also rejects the four sets of rules proposed for these transactions in the American Law Institute's *Principles of Corporate Governance: Analysis and Recommendation*.

This proposal would also override all state takeover laws, such as control share statutes, business combination statutes and disgorgement statutes, which generally have the purpose or effect of protecting incumbent management.

By placing the control of the change of control process in the hands of truly disinterested directors and applying the business judgment rule in all cases in which a change of control board acts, this proposal should cure the problem of unpredictability and vagueness, should result in a substantial decrease in litigation in change of control situations, and should enhance the efficiency of the change of control market.
CHANGE OF CONTROL BOARD: FEDERAL PREEMPTION OF THE LAW GOVERNING A TARGET'S DIRECTORS

Samuel C. Thompson, Jr.*

I. INTRODUCTION

This article sets out a proposed federal uniform standard governing the actions by the board of directors of a publicly-
held corporation that is the target of a change of control board transaction. This proposal would apply in each of the following four merger and acquisition transactions:

1. The acquisition of a target in an arm’s-length negotiated merger or acquisition;
2. The acquisition of a target in a management buyout;
3. The proposed acquisition of a target in a hostile tender offer; and
4. The acquisition by a target’s controlling shareholder of the minority interests in such target in a freezeout merger.

Under this proposal, an independent and knowledgeable change of control board would be appointed for the target, and this board would have complete authority over the acquisition process. Because of the board’s obvious independence, one uniform governance standard, the business judgment rule, would apply in determining if the board acted properly.

This article proposes that federal law preempt state law rules governing the actions of a publicly-held target’s board in each of these transactions. However, this is only a default rule because a corporation’s shareholders could elect not to have the provision apply or could elect to have it apply only in certain circumstances, such as in a hostile tender offer. The adoption of this provision would, therefore, enhance the competition for corporate governance rules in change of control transactions.

This proposal would replace the four separate governance rules generally applicable to a target’s directors under Delaware and other state law in arm’s-length transactions, management buyouts, tender offers, and freezeouts. This article

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1 This article does not address the issue of the proper treatment of the acquiring corporation, unless the target’s shareholders after the acquisition end up with more than 50% of the acquiror stock. See infra Part III.B. Several proposals exist for the treatment of the acquirer. See John R. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer’s Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1269-72 (1984) (suggesting that acquiror’s shareholders have right to vote on acquisitions above certain size); George W. Dent, Jr., *Unprofitable Mergers: Toward a Market Based Legal Response*, 80 NW. U. L. REV. 777, 794-806 (1986) (proposing that courts enjoin acquisitions where announcement of which causes material decline in price of acquiror’s stock).
also rejects the four sets of rules proposed for these transac-
tions in the American Law Institute’s Principles of Corporate
Governance: Analysis and Recommendation. However, the
scope of authority of a change of control board, the duty of
care governing the actions of a change of control board, and
the formulation of the business judgment rule protection for a
change of control board are based on analogous provisions of
the ALI’s Corporate Governance Project.

This proposal would also override state takeover laws, such
as control share statutes, business combination statutes, and
disgorgement statutes, which generally have the purpose or
effect of protecting incumbent management.

In a recent article, Professors Bebchuck and Ferrell of
Harvard Law School stated the following:

Our analysis of Delaware takeover law highlights the fact
that its rules governing defensive tactics seem to be charac-
terized by unnecessary ambiguity and unpredictability, result-
ing in frequent litigation. While this aspect of Delaware law
benefits the interest of the Delaware bar, which might be of
importance to Delaware, it is difficult to see how shareholders
are benefited by the excessive unpredictability and vagueness
of its rules.

Since the corporate governance rules proposed by the ALI are
similar to those in Delaware, it could be expected that the
adoption of the ALI rules would not solve this problem of un-
predictability and vagueness. On the other hand, by placing the
control of the change of control process in the hands of truly
disinterested and informed directors and applying the business
judgment rule in all cases in which a change of control board
acts, this proposal should cure the problem of unpredictability

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2 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALY-
SIS AND RECOMMENDATION (vols. 1 and 2) (1994) [hereinafter CORPORATE GOVER-
NANCE PROJECT]. The ALI’s approach to these four transactions is explored in
detail in Samuel C. Thompson, Jr., The Merger and Acquisition Provisions of the
ALI Corporate Governance Project As Applied to the Three Steps in the Time-

3 Lucian Arye Bebchuk & Allen Ferrell, Federalism and Corporate Law: The
Race to Protect Managers from Takeovers, 99 COLUM. L. REV. 1168, 1172 (1999).
and vagueness, should result in a substantial decrease in litigation in change of control situations, and should enhance the efficiency of the change of control market.

I must emphasize that this article is not an attack on the Delaware judiciary or bar; as a teacher of corporate law, I believe that Delaware has the most knowledgeable corporate law judges and many of the most knowledgeable corporate lawyers in the country. Adoption of this proposal would only reduce the role of the Delaware bench and bar in change of control transactions; they would continue to be active in other areas of corporate law.

While most readers of this article will likely have an initial adverse reaction to the idea of federalizing any aspect of state corporate law, the purpose and effect of this proposal is to reduce regulatory and judicial interference in the market for corporate control. Thus, both those who believe the current federal system produces a "race to the bottom" and those who believe the system produces a "climb to the top" should support this proposal.

Section II of this article sets out the rationale for the change of control board concept by illustrating the conflicts of interest existing under current law and showing how this proposal would remedy these conflicts and provide other benefits. This section also reviews the proposals in the ALI Corporate Governance Project for the treatment of change of control transactions and discusses why these proposals are not an adequate substitute for the change of control board concept.

Section III discusses in detail the operation of the change of control board concept and outlines the collateral changes to the federal securities laws that would be needed if the change of control concept were adopted. To facilitate analysis of this proposal, the Appendix contains a suggested amendment (i.e., Proposed Section 14A) to the Securities Exchange Act of 1934 (the "1934 Act") detailing the operation of the change of control board concept.

Section IV illustrates how the change of control board concept would have applied in several leading cases. Section V then discusses why the use of the current concept of disinter-
ested directors does not effectively address the fundamental conflict problem in change of control situations.

Section VI examines whether a federal uniform governance standard is consistent with the empirical evidence bearing on the advisability of federalizing corporate law. Section VII surveys various other proposals for addressing change of control transactions, and Section VIII compares the change of control board concept with the rules governing takeovers in the United Kingdom, Germany, and the European Union. Section IX analyzes the negative comments of several merger and acquisition practitioners on this proposal, and finally, Section X, the conclusion, provides a summary of the arguments in support of the adoption of the change of control concept.

II. RATIONALE FOR THE CHANGE OF CONTROL BOARD

A. Introduction

The basic purpose of the change of control board is to eliminate the potential conflict of interest facing a target’s board in each of the four acquisition transactions mentioned above. Potential conflict is apparent and well recognized in management buyouts, tender offers, and freezeouts.

The potential conflicts also exist in arm’s-length transactions, because the target’s board or senior managers may receive in connection with such a merger or acquisition a collateral payment, such as a golden parachute payment or a post-acquisition employment agreement. Deutsche Bank AG’s acquisition of Bankers Trust Corporation in an arm’s-length transaction provides a good illustration of these potential conflicts. The merger agreement provided for substantial annual payments to several of the top officials of Bankers Trust, including a $10.1 million annual bonus to the Chairman and Chief Executive Officer, Frank Newman. Shortly after completion of the transaction, Mr. Newman resigned "with a controversial $69 million pay package after failing to land a spot on Deutsche Bank’s board and after reports that Bankers Trust

used unclaimed customer funds to pump up its bottom line. It is highly likely that Mr. Newman would not have received payments at these levels if a change of control board had been in place for Bankers Trust. On the other hand, nothing here would limit the post merger compensation an acquiror could pay the target's top management.

The discussion below illustrates the conflicts in several leading change of control cases and shows how the current corporate governance rules address these issues. Also, the rules for change of control transactions proposed in the ALI Corporate Governance Project are examined. Neither the current rules nor the rules proposed in the Project adequately address these transactions.

B. Illustration of Conflicts and Current Law Governance Rules for Mergers and Acquisitions

1. Introduction

This section examines several seminal cases that illustrate the potential conflicts in arm's length, management buyout, tender offer, and freezeout transactions. The section below dealing with arm's length transactions considers the Delaware Supreme Court's decisions in (1) Smith v. Van Gorkom,\(^6\) (2) Paramount Communications, Inc. v. Time, Inc. (Time-Warner),\(^7\) and (3) Paramount Communications, Inc. v. QVC Network, Inc. (QVC).\(^8\) Although Time-Warner and QVC resulted in hostile tender offers, they started as arm's-length negotiated transactions.\(^9\)

The section which addresses management buyouts looks at the Second Circuit's 1986 decision in Hanson Trust PLC v. ML SCM Acquisition, Inc.\(^10\) and the Delaware Chancery Court's 1996 decision in Kahn v. Dairy Mart Convenience Stores, Inc.\(^11\)

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\(^6\) 488 A.2d 858 (Del. 1985).

\(^7\) 571 A.2d 1140 (Del. 1989).

\(^8\) 637 A.2d 34 (Del. 1993).


\(^10\) 781 F.2d 264 (2d Cir. 1986).

In considering tender offers, the Delaware Supreme Court's decisions in (1) *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, (2) *Time-Warner*, and (3) *QVC* are examined. This section also examines a Delaware federal district court's decision under Delaware law in *Moore Corp. v. Wallace Computer Services, Inc.* and the Pennsylvania federal district court's decision under Pennsylvania law in *Norfolk Southern Corp. v. Conrail, Inc.* In addition, this section discusses the Delaware standard governing the actions of a target's directors in a tender offer as reflected in *Unocal Corp. v. Mesa Petroleum Co.* and *Unitrin, Inc. v. American General Corp.*

The section focusing on freezeouts examines the Delaware Supreme Court's decisions in *Weinberger v. UOP, Inc.* and *Kahn v. Lynch Communication Systems, Inc.* These decisions are briefly summarized below. Although many other cases could be discussed, these cases illustrate the conflicts that can arise in the four types of change of control transactions addressed here. Section IV discusses the manner in which the change of control board proposal would have applied in each of these cases.

2. Arm's-length Transactions

*Smith v. Van Gorkom* was an arm's-length acquisition in which Trans Union, a publicly-held corporation, was acquired in a cash merger by Marmon, a corporation controlled by the Pritzker family. The chief executive officer of Trans Union, Van Gorkom, was the driving force behind the transaction. He was a major shareholder of Trans Union and was about to

13 506 A.2d 173 (Del. 1986).
16 493 A.2d 946 (Del. 1985).
17 651 A.2d 1361 (Del. 1995).
18 457 A.2d 701 (Del. 1983).
20 Van Gorkom, 488 A.2d at 865-70.
21 Id. at 865-66.
reach retirement age. After consulting with Trans Union's controller concerning an acceptable acquisition price for Trans Union, but without consulting Trans Union's investment banker, Van Gorkom suggested to Jay Pritzker that Marmon acquire Trans Union at a price of $55 per share. This price was a substantial premium over the market price of the Trans Union shares. Jay quickly accepted the offer but demanded a lock-up option to purchase a substantial number of Trans Union shares at $.75 above market. He also demanded that Trans Union not shop the deal. Van Gorkom accepted both terms. Over the objection of some members of senior management, Trans Union's Board approved the transaction at a hastily-called two-hour meeting.

The Delaware Supreme Court noted that since Van Gorkom was approaching retirement age, he may have been particularly motivated to effectuate a quick sale of the company and of his shares. Notwithstanding this potential conflict, the court did not find that Van Gorkom had a legally cognizable conflict of interest sufficient to take the transaction out of the business judgment rule.

The board consisted of a majority of outside directors who were found by the court to be sophisticated, experienced in business affairs, and well informed about Trans Union's finances. The court held, however, that the directors "did not adequately inform themselves as to Van Gorkom's role in forcing the 'sale' of the Company... [and] were grossly negligent in approving the 'sale'... upon two hours consideration..." The court, therefore, denied the directors the

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22 Id. at 866.
23 Id.
24 Id. at 869 n.9.
25 Van Gorkom, 488 A.2d at 866.
26 Id. at 868.
27 Id. at 867.
28 Id. at 869.
29 Id. at 866.
30 Van Gorkom, 488 A.2d at 868.
31 Id. at 874.
protection of the business judgment rule and remanded for a determination of damages.32

A quick reading of the facts of the Van Gorkom case leads one to ask why a sophisticated executive like Van Gorkom would follow such a casual procedure in selling an undervalued public corporation. One might argue Van Gorkom was motivated by something other than a desire to maximize the long-term interest of the shareholders. This is so even though Van Gorkom was a major shareholder himself. It may have been that he was interested most in maximizing what he perceived to be his own short term interest by effectuating a quick sale while he was still in control of the corporation.

In criticizing the court's decision, Professor Fischel argues:

Van Gorkom had strong incentives to negotiate the best deal possible. The transaction was negotiated at arm's-length; moreover, Van Gorkom was himself a large shareholder. The better the deal that Van Gorkom negotiated, the more money he made himself. . . . Van Gorkom was one year away from retirement and thus had no reason to block a merger in the interest of keeping his job.33

While all of these points are true, they do not contradict the observation that Van Gorkom presumably had a personal interest in seeing a quick sale of the company and that he may have let his personal interest lead him to an unwise decision to sell.

The Van Gorkom decision also illustrates that independent directors are not necessarily reliable as a check on strong insiders like Van Gorkom. The adoption of the change of control board concept proposed here would eliminate the potential for a strong chief executive to dominate a target's decision-making process in a change of control situation. Although the change of control board would be expected to consult with the corporation's senior managers and its board, it is highly unlikely that the control board would permit itself to be dominated.

32 Id. at 893.
In both the *Time-Warner* and *QVC* transactions, which are examined in more detail below in connection with tender offers, the boards of corporations that ultimately became the targets of hostile tender offers (i.e., Time and Paramount) negotiated arm's-length merger agreements with friendly corporations. The boards of both these companies had a majority of independent directors. Both merger agreements contained provisions designed to discourage third party bids, and, at the time the merger agreements were entered into, the boards of both Time and Paramount knew that other firms were interested in acquiring them. It is inconceivable that a change of control board would have entered into either of these "arm's-length" transactions without first thoroughly exploring other potential transactions.

3. Management Buyouts

In *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, Hanson made a tender offer for SCM, and in response, several of SCM's inside directors, together with Merrill Lynch, proposed a leveraged management buyout as an alternative to Hanson's offer. In evaluating the two offers, SCM's board acted through a committee of disinterested directors who were advised by the investment banking firm of Goldman Sachs and the law firm of Wachtell Lipton.

On the advice of Goldman and Wachtell, the disinterested directors granted a crown jewel lock-up option to the management group. At this point, the offer of the management group was for cash and stock with an aggregate estimated value of $72.50 per share, and Hanson's offer was for cash of $72 per share. Hanson subsequently increased its offer to

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3 Time-Warner, 571 A.2d 1140, 1143 (Del. 1989); QVC, 637 A.2d 34, 34 (Del. 1993).
35 Time-Warner, 571 A.2d at 1143; QVC, 637 A.2d at 34.
37 781 F.2d 264 (2d Cir. 1986).
38 *Hanson Trust*, 781 F.2d at 268-69.
39 Id. at 267-68.
40 Id. at 270.
41 Id. at 271.
$75 per share in cash.\textsuperscript{42} In addition to the lock-up option, SCM also granted the management group a no-shop agreement and paid Merrill Lynch's fees for entering the bidding ("hello fees") and agreed to pay Merrill a fee in the event its offer failed (a "goodbye fee").\textsuperscript{43}

Although Goldman Sachs advised the disinterested directors that the option prices were within the range of fair value, the court found that the option prices were substantially under-valued and that "the disinterested directors never asked Goldman what the stock would generate at top value."\textsuperscript{44}

The Second Circuit Court of Appeals, applying New York law, observed that it appeared as if Goldman, Wachtell, and the disinterested directors wanted the management group to prevail.\textsuperscript{45} The court nevertheless found that the disinterested directors were not interested in the transaction and acted in good faith and without fraud, which are the normal conditions for protection under the business judgment rule.\textsuperscript{46} The court went on to say, however, that this was not enough and that the directors were required to meet the "standard of due care" with "conscientious fairness."\textsuperscript{47} The court elaborated on this point as follows:

The law is settled that, particularly where directors make decisions likely to affect shareholder welfare, the duty of due care requires that a director's decision be made on the basis of 'reasonable diligence' in gathering and considering material information. In short, a director's decision must be an informed one.\textsuperscript{48}

In support of this proposition the court cited a draft of the ALI Corporate Governance Project.\textsuperscript{49}

\textsuperscript{42} Id. at 272.
\textsuperscript{43} Hanson Trust, 781 F.2d at 270.
\textsuperscript{44} Id. at 275.
\textsuperscript{45} Id. at 272-73.
\textsuperscript{46} Id. at 274.
\textsuperscript{47} Id.
\textsuperscript{48} Hanson Trust, 781 F.2d at 274.
\textsuperscript{49} Id.
The court went on to find that although the actions of the disinterested directors did not amount to gross negligence as in *Van Gorkom*, the disinterested directors did not properly inform themselves of the value of the optioned assets. Consequently, their actions were not protected by the business judgment rule. The burden, therefore, switched to the disinterested directors to prove that the option price was either fair or in the interest of the shareholders, and the directors failed to meet this burden. The option was, therefore, enjoined.

*Kahn v. Dairy Mart Convenience Stores, Inc.* applies Delaware law in a management buyout in which the target was to be acquired by an entity controlled by the target's controlling shareholder. In such case, the entire fairness test applies. Further, under *Lynch*, which is discussed below in connection with freezeouts, the burden of proof is on the defendant to establish that the transaction is entirely fair, unless there is a "properly functioning committee of independent directors representing the interest of the minority ..." In such a case, the burden shifts to the plaintiff. In *Dairy Mart*, the court said that it could not find as a matter of law that the independent committee functioned properly. One of the two members of the committee was a paid consultant to the target, and the committee did not attempt to negotiate a higher price than that offered by the management group because the controlling shareholder would not permit the target to consider any other offers. Also, the court pointed out that in this situation, "the selection of professional advisors for the committee doesn't give

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50 *Id.* at 275.
51 *Id.*
52 *Id.* at 277-83.
53 *Hanson Trust*, 781 F.2d at 283.
56 *Id.* at *8, 21 DEL. J. CORP. L. at 1156.
57 *Id.* at *6, 21 DEL. J. CORP. L. at 1156.
58 *Id.*
59 *Id.* at *7-8, 21 DEL. J. CORP. L. at 1157.
60 *Dairy Mart*, 1996 WL at *7-8, 21 DEL. J. CORP. L. at 1157-58.
comfort, it raises questions." Finding that it could not conclude as a matter of law that the transaction was entirely fair, the court denied the defendant's motion for summary judgment.

Under Delaware law, if it is clear that the independent directors are the decision-makers for the target, and these directors are not in any way related to the buyout group, the business judgment rule may apply.

_Hanson Trust_ shows that even though disinterested directors may not have a legally cognizable interest in a transaction, they may have a bias for management that deters their ability to act vigorously in promoting the welfare of shareholders. It is highly unlikely that any change of control board would conduct itself like the boards in _Hanson Trust_ or in _Dairy Mart_. Also, the legal and other advisors to the change of control board would not be beholden to the senior management, as was apparently the case in _Hanson Trust_.

4. Tender Offer Defensive Tactics

_Revlon v. MacAndrews & Forbes Holdings, Inc._ involved a battle for control of Revlon between Pantry Pride and Forstmann Little, which acted as a "white knight" in coming to the rescue of Revlon. The board of Revlon granted an auction ending lock-up to Forstmann, which Revlon favored throughout the process, even though Forstmann's offer was not clearly superior to Pantry Pride's offer. As part of its offer, Forstmann agreed to support the value of Revlon's outstanding notes, which had been issued by Revlon as a defensive tactic in exchange for part of its outstanding stock.

In setting out the legal standard to be applied in the case, the Delaware Supreme Court first noted that under the busi-
ness judgment rule, the directors get the benefit of a presumption that in making a decision they acted: (1) on an informed basis, (2) in good faith, and (3) in the honest belief that the action taken was in the best interest of the corporation. The court noted that this rule did not apply here, because in this situation the enhanced duty adopted by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.* applies. The *Unocal* court noted that when a board adopts takeover defenses there arises "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders..." If directors act in their own self-interest, the business judgment rule does not apply, because disinterestedness is one of the conditions for application of the rule. The *Revlon* court went on to set out the *Unocal* enhanced standard as follows:

This potential for conflict places upon the directors the burden of proving that they had reasonable grounds for believing there was a danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation. In addition, the directors must analyze the nature of the takeover and its effect on the corporation in order to ensure balance — that the responsive action taken is reasonable in relation to the threat posed.

Thus, as a result of the potential conflict of interest inherent in the adoption of takeover defenses, the *Revlon* directors had the burden of proving first that they acted in good faith and conducted a reasonable investigation. Proof of these elements would show reasonable grounds for believing there was a danger to corporate policy and effectiveness. The directors

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68 *Id.* at 180 (citing Aronson v. Lewis, 473 A.2d 805, 812 (1984)).
69 *Id.* (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)).
70 *Unocal*, 493 A.2d at 954.
71 *Revlon*, 506 A.2d at 180.
72 *Id.* (citations omitted).
73 *Id.*
74 *Id.*
then had to show that their defensive measures were reasonable in relation to the threat posed.\textsuperscript{75}

In addressing the issue of whether there was a threat to Revlon's corporate policy and effectiveness, the court reasoned as follows: at the point in the bidding war that it became apparent that the break-up of Revlon was imminent, the "duty of the board changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit."\textsuperscript{76} At this point, "the question of defensive measures became moot, [and] [t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."\textsuperscript{77}

In applying this legal standard, the court found that the "principal object" of the Revlon board in granting the lock-up option "appears to have been protection of the noteholders over the shareholders' interest."\textsuperscript{78} The board was concerned that if Pantry Pride's offer succeeded, the notes would lose value and the directors could be held personally liable.\textsuperscript{79}

The court reasoned that although lock-ups and related agreements are permitted when not tainted by director interest and other breaches of fiduciary duty, the actions taken by the Revlon directors did not satisfy this disinterested standard.\textsuperscript{80} Further, citing \textit{Unocal}, the court said that a "board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."\textsuperscript{81}

Further, the court stated that the noteholders had accepted the notes subject to fixed contractual terms and, therefore, "nothing remained for Revlon to legitimately protect, and no rationally related benefit thereby accrued to the stockhold-

\textsuperscript{75} \textit{Id.}
\textsuperscript{76} \textit{Revlon}, 506 A.2d at 182.
\textsuperscript{77} \textit{Id.}
\textsuperscript{78} \textit{Id.} at 184.
\textsuperscript{79} \textit{Id.}
\textsuperscript{80} \textit{Id.}
\textsuperscript{81} \textit{Revlon}, 506 A.2d at 182.
ers." Consequently, "the merger agreement with Forstmann was unreasonable in relation to the threat posed," and, therefore, the court enjoined the merger, the no-shop agreement, and the payment of cancellation fees.

Revlon demonstrates that although a target's board may not have a legally cognizable interest in the acquiring vehicle, it may have other reasons for favoring one party to a takeover at the expense of the shareholders. In this regard the court noted:

Revlon had dealt preferentially, and almost exclusively, with Forstmann throughout the contest. After the directors authorized management to negotiate with other parties, Forstmann was given every negotiating advantage that Pantry Pride had been denied: cooperation from management, access to financial data, and the exclusive opportunity to present merger proposals directly to the board of directors. The directors cannot fulfill their enhanced Unocal duties by playing favorites with the contending factions.

In elaborating on the second prong of the Unocal test—that the defensive measures be balanced—the Delaware Supreme Court in Unitrin, Inc. v. American General Corp. held that a defensive action could not be coercive or preclusive and must fall within a range of reasonableness. At a minimum, the actions of Revlon's board would appear to be preclusive.

The adoption of the change of control board concept would avoid the type of favoritism shown by Revlon's board for the Forstmann offer. It can be expected that a change of control board would be fiercely loyal and diligent in pursuing the welfare of the target's shareholders.

In Time-Warner, Time and Warner agreed to a stock for stock merger in which Time would acquire Warner in a reverse subsidiary merger, with the Warner shareholders owning 62%
of the resulting company, Time-Warner. The merger agreement contained certain defensive measures such as a "no-shop," and Time had a poison pill in place. Delaware law provided that Warner's shareholders had to approve the merger, and the New York Stock Exchange (NYSE) rules provided that Time's shareholders had to approve the transaction.

After Time and Warner mailed their proxy material, Paramount made an "all cash, all shares" tender offer for Time at $175 per share. Time's board found this offer inadequate and restructured its acquisition with Warner as a two-step transaction as follows: first, a cash tender offer for 51% of Warner's shares at $70 per share; second, a freezeout merger for Time-Warner securities also at $70 per share. Paramount increased its tender offer for Time to $200 per share, but Time's board also rejected this offer as inadequate. As pointed out by Chancellor Allen in the lower court opinion, Time's investment banker, Wasserstein Perella, rendered an opinion that Time was worth substantially more than $200 per share. In commenting on Wasserstein's prediction that the trading range for Time's shares in 1993 would be between $208 and $402, Chancellor Allen said that this is a "range that a Texan might feel at home on."

Certain shareholder plaintiffs brought action against Time arguing that under Reulon, Time was required to auction itself because by entering into the transaction with Warner and adopting the protective devices, Time had put itself in play. Paramount and the shareholder plaintiffs also brought a Unocal claim against Time's board.

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88 Time-Warner, 571 A.2d at 1146.
89 Id.
90 Id. at 1147.
91 Id. at 1148.
92 Id. at 1149.
94 Id.
95 Time-Warner, 571 A.2d at 1149.
96 Id.
The court first held that Time's board acted on an informed basis in negotiating the original merger, and consequently, this transaction was protected by the business judgment rule.\footnote{Id. at 1150.}

Second, the court held that even though the Time shareholders would have become minority shareholders of Time-Warner, there was no change of control of Time because the stock of Time-Warner would be in the hands of a “fluid aggregation of unaffiliated shareholders.”\footnote{Id. at 1150.} Consequently, Time had not put itself up for sale, and the \textit{Revlon} auction requirement was not applicable.\footnote{Id. at 1151.}

Third, the court held that in structuring the tender offer for Warner, Time initiated a defensive tactic that was governed by \textit{Unocal}.\footnote{Time-Warner, 571 A.2d at 1151.} Under the first part of the \textit{Unocal} test, Time correctly concluded that Paramount’s offer posed a “cognizable threat” to Time’s “culture.”\footnote{Id. at 1153.} Under the second part of the \textit{Unocal} standard, the Court found Time’s tender offer for Warner to be reasonable in relation to the threat posed.\footnote{Id. at 1155.} Thus, the court let Time reject Paramount’s offer and proceed with its transaction with Warner.\footnote{Id.}

In \textit{QVC}, after several discussions, Paramount and Viacom entered into a merger agreement pursuant to which Viacom, which was controlled by Sumner Redstone, would acquire Paramount.\footnote{QVC, 637 A.2d 34 (Del. 1993).} The consideration originally to be paid by Viacom was Class A voting stock, Class B non-voting stock and $9.10 in cash, with an aggregate value of approximately $70 per share of Paramount.\footnote{Id. at 39.} The merger had (1) a no shop, (2) a termination fee of $100 million, and (3) a stock option on 19.9\% of Paramount’s stock.\footnote{Id. at 34 (Del. 1993).} The stock option could be paid for by Viacom’s subordinated note, and as an alternative to

\begin{footnotesize}
\begin{enumerate}
\item Id. at 1150.
\item Id. at 1150.
\item Id. at 1151.
\item Time-Warner, 571 A.2d at 1151.
\item Id. at 1153.
\item Id. at 1155.
\item Id.
\item 637 A.2d 34 (Del. 1993).
\item QVC, 637 A.2d at 39.
\item Id.
\item Id.
\end{enumerate}
\end{footnotesize}
exercising of the option, Viacom could “put” the option to Paramount for the bargain element inherent in the option.\textsuperscript{108} Also, Paramount had a poison pill, and Paramount’s CEO was to continue to run Paramount.\textsuperscript{109}

“Paramount wanted at least $70 per share.”\textsuperscript{110} QVC countered with a proposed merger for cash and stock at $80 per share.\textsuperscript{111} Paramount’s board of directors refused to negotiate with QVC because of an unsatisfied financing condition.\textsuperscript{112}

QVC later made a tender offer for 51% of Paramount’s stock to be followed by a second step merger for common stock of QVC.\textsuperscript{113} At this point, QVC’s bid was $10 higher than Viacom’s merger consideration.\textsuperscript{114}

Viacom and Paramount then renegotiated their deal as a tender offer by Viacom for 51% of Paramount’s stock to be followed by a second step merger for Viacom stock with a price of $80 per share at both stages.\textsuperscript{115}

QVC’s proposed fair bidding process was rejected, and Viacom and Paramount amended Viacom’s tender offer to $85 in cash with $85 in stock in the second step merger.\textsuperscript{116} QVC then amended its bid to $90 in cash with $90 in stock on the back end.\textsuperscript{117}

These offers can be summarized as follows:

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<tr>
<td>(1) Viacom</td>
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<td>(2) QVC</td>
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<td>(3) Viacom</td>
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<td>(4) Viacom</td>
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<td>(5) QVC</td>
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\textsuperscript{108} \textit{Id.}
\textsuperscript{109} \textit{Id.}
\textsuperscript{110} \textit{QVC, 738 A.2d at 39.}
\textsuperscript{111} \textit{Id.}
\textsuperscript{112} \textit{Id. at 40.}
\textsuperscript{113} \textit{Id.}
\textsuperscript{114} \textit{Id.}
\textsuperscript{115} \textit{QVC, 637 A.2d at 40.}
\textsuperscript{116} \textit{Id. at 41.}
\textsuperscript{117} \textit{Id.}
Paramount's board of directors determined that QVC's $90 offer was not in the best interests of the corporation.\textsuperscript{118} Also, Paramount's board of directors did not negotiate with QVC because of the unsatisfied financing contingency.\textsuperscript{119}

The court first noted there are rare cases in which a court will "take a more direct and active role in overseeing" a board's decisions.\textsuperscript{120} In such cases the court subjects the directors to "enhanced scrutiny" to ensure reasonableness citing, inter alia, Unocal and Revlon.\textsuperscript{121} The court said that this case raises two situations that implicate enhanced scrutiny: (1) a sale of control and (2) defensive measures.\textsuperscript{122}

There was a sale of control because Sumner Redstone was in control of Viacom and would become the controlling shareholder of Paramount.\textsuperscript{123} This is distinguished from Time-Warner, where the stock of Time after the acquisition would be held by a "fluid aggregation of unaffiliated shareholders representing a voting majority."\textsuperscript{124} Paramount's shareholders were entitled to a control premium, and, in the absence of such a premium, the directors had an obligation to get the shareholders the "best value reasonably available" (BVRA).\textsuperscript{125} Thus, in a sale of control situation, enhanced scrutiny applies.\textsuperscript{126}

The court reasoned that where directors take action to cause a change of control or to break-up the target, they have an obligation to seek the BVRA.\textsuperscript{127} Thus, Time-Warner is not controlling in such a situation.\textsuperscript{128} The court went on to state that "[t]he Paramount Board, albeit unintentionally, had 'initiate[d] an active bidding process seeking to sell itself' by agreeing to sell control of the corporation to Viacom in circumstances where another potential acquiror (QVC) was equally

\begin{itemize}
  \item \textsuperscript{118} Id.
  \item \textsuperscript{119} Id.
  \item \textsuperscript{120} QVC, 637 A.2d at 42.
  \item \textsuperscript{121} Id.
  \item \textsuperscript{122} Id.
  \item \textsuperscript{123} Id. at 43.
  \item \textsuperscript{124} Time-Warner, 571 A.2d at 1150.
  \item \textsuperscript{125} QVC, 637 A.2d at 43.
  \item \textsuperscript{126} Id.
  \item \textsuperscript{127} Id. at 43-44.
  \item \textsuperscript{128} Id. at 46-48.
\end{itemize}
interested in being a bidder." Also, the court found that the defensive tactics (i.e., the pill, the no shop, the termination fee, and the stock option) were not reasonable.

In Moore Corp. v. Wallace Computer Services, Inc., the acquiring corporation, Moore, made an acquisition proposal to Wallace, which was rejected. Moore then made an "any and all" tender offer at $56 per share with a back end merger at that price. Moore also started a proxy contest to unseat Wallace’s board of directors and redeem its pill. The $56 price was a 27% premium over the pre-offer price. Wallace retained Goldman Sachs, which gave an opinion that the $56 was "inadequate." Moore increased its offer to $60, but Goldman gave another inadequacy opinion. Goldman was not asked to value Wallace.

The court found that Wallace’s actions were defensive and that the Unocal standard, therefore, applied. The court went on to find that Moore’s action posed a threat because the price offered was, under the circumstances, inadequate and that Wallace’s directors’ action in not redeeming the pill was proportionate, thereby satisfying the Unocal standard. Thus, although 73.4% of Wallace’s shareholders tendered their shares to Moore, Wallace was permitted to "just say no" by keeping its pill in place.

In Norfolk Southern Corp. v. Conrail, Inc., CSX, a railroad company and the acquiror, entered into a merger agree-

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129 Id. at 47.
130 QVC, 637 A.2d at 48-51.
132 Moore, 907 F. Supp. at 1550.
133 Id. at 1551.
134 Id. at 1550-51.
135 Id. at 1551.
136 Id. at 1551-52.
137 Moore, 907 F.2d at 1553.
138 Id. at 1552-53.
139 Id. at 1553-54.
140 Id. at 1560, 1564.
141 Id. at 1553.
142 Moore, 907 F. Supp. at 1563.
ment with Conrail, also a railroad company and the target, pursuant to which CSX was to acquire Conrail in a multi-step acquisition for $92.50 per share, which was later raised to $110 per share.\textsuperscript{144} Norfolk Southern, also a railroad company, and also a shareholder of Conrail, sought vigorously to block the merger and made a competing bid for Conrail at $100 per share and then raised its offer to $115 per share.\textsuperscript{145}

Conrail was a Pennsylvania corporation that was subject to the provisions of the Pennsylvania business corporation law governing takeovers.\textsuperscript{146} The court specifically found that the intent of these Pennsylvania provisions is to reject such Delaware cases as \textit{Unocal} and \textit{Revlon}.\textsuperscript{147}

In a series of opinions from the bench, the District Court specifically found that the defensive measures employed by Conrail, including a poison pill and a no shop (which was effective for a two-year period) were in accord with Pennsylvania law.\textsuperscript{148} Consequently, the Conrail board could keep its poison pill and other defensive measures intact.\textsuperscript{149}

Notwithstanding this decision, CSX and Norfolk Southern subsequently reached an agreement with Conrail pursuant to which CSX acquired Conrail for $115 per share, and CSX and Norfolk then split up the Conrail assets.

As indicated below, if the change of control provision had applied in \textit{Time-Warner}, \textit{QVC}, \textit{Moore}, and \textit{Norfolk Southern}, either the likely outcomes would have been different or the outcome would have been similar but without the costs and expense of litigation.

\textbf{5. Freezeout Mergers}

\textit{Weinberger v. UOP, Inc.}\textsuperscript{150} involved a freezeout merger in which Signal Companies, Inc., a controlling shareholder of UOP with a 50.5% stock interest, acquired all of UOP's shares in a

\textsuperscript{145} Id. at *15.
\textsuperscript{146} Id. at *2.
\textsuperscript{147} Id. at *5-7.
\textsuperscript{148} Id. at *4-6.
\textsuperscript{149} Id. at *5-6.
\textsuperscript{150} Norfolk S., 1997 U.S. Dist., lexis 879, at *5-6.
\textsuperscript{151} 457 A.2d 701 (Del. 1983).
cash merger transaction. Signal's executives, Arledge and Chitiea, who were also directors of UOP, decided "that it would be a good investment for Signal" if it could acquire the minority held UOP shares for any price up to $24 per share. Signal's executive committee settled on a price of $20-21 per share, and Signal's board concluded that the $20-$21 price would be fair to both Signal's shareholders and UOP's shareholders. Signal had previously paid $21 for UOP shares, and the shares were now trading for almost $14 per share.

Signal's executives met with UOP's president, Crawford, to discuss the deal. Crawford, who had been a prior employee of Signal, did not object to the $20-$21 price, but he had other discussions regarding retention of UOP's employees. Crawford retained the Lehman Brothers investment banking firm "to render a fairness opinion" on the transaction. One of Lehman Brothers' partners was a member of UOP's board.

Lehman Brothers rendered an opinion that $21 per share was fair. The court noted that the opinion was prepared on a rush basis. UOP's board met to consider the transaction and, with only the outside directors voting, the transaction was approved at the price of $21 per share. The UOP board apparently was not advised that Signal's executives had concluded that any price up to $24 per share would be a good investment for Signal.

The merger agreement was structured so that a majority of UOP's minority shareholders and two-thirds of all shareholders

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151 Weinberger, 457 A.2d at 701.
152 Id. at 705.
153 Id.
154 Id. at 704.
155 Id. at 705.
156 Weinberger, 457 A.2d at 705.
157 Id. at 706.
158 Id.
159 Id. at 707.
160 Id. at 708.
161 Weinberger, 457 A.2d at 707.
162 Id.
were required to approve the transaction, and this approval was obtained.\textsuperscript{163}

Minority shareholders brought a class action alleging that the price paid was unfair.\textsuperscript{164} In discussing the governing law, the Delaware Supreme Court reasoned that a controlling shareholder generally has the burden of establishing fairness in a freezeout merger.\textsuperscript{165} However, the court held that if the merger has been approved by a majority of the minority shareholders and the controlling shareholder shows complete disclosure of all material facts, then “the burden entirely shifts to the plaintiffs to show that the transaction was unfair to the minority.”\textsuperscript{166} Here, the Supreme Court found a failure on the part of Signal to show complete disclosure.\textsuperscript{167} The court held that Arledge and Chitiea, as officers of both Signal and UOP, failed in their “duty of good management to both corporations.”\textsuperscript{168}

The court’s analysis centered around two fundamental aspects of the entire fairness doctrine: “fair dealing and fair price.”\textsuperscript{169} The concept of fair dealing asks courts to determine the fairness of all stages of negotiation between the parties involved.\textsuperscript{170} Fair price considerations involve an examination of “the economic and financial considerations of the proposed merger.”\textsuperscript{171} Courts weigh these concepts in order to make a general determination of the fairness of the transaction.\textsuperscript{172}

The court concluded Signal breached its duty of fairness under both tests.\textsuperscript{173} Signal was not engaged in fair dealing because Arledge and Chitiea failed to disclose to UOP directors that Signal considered as high as $24 per share to be a fair purchase price of the remaining minority stock.\textsuperscript{174} By virtue of

\begin{footnotesize}
\begin{enumerate}
\item Id. at 707-08.
\item Id. at 703.
\item Id.
\item Id. at 705, 710-11.
\item Id. at 711.
\item Id. at 712, 714.
\item Id. at 712.
\item Weinberger, 457 A.2d at 703.\textsuperscript{166}12
\item Id.
\item Id. at 705, 710-11.
\item Id. at 711.
\item Id.
\item Weinberger, 457 A.2d at 711.
\item Id.
\item Id. at 712, 714.
\item Id. at 712.
\end{enumerate}
\end{footnotesize}
Signal's failure to disclose that fact, the court also found Signal breached its duty to negotiate a fair purchase of the minority shareholders' stock in UOP.\textsuperscript{175}

The court also suggested in a footnote that Signal should have adopted an independent negotiating structure for determining the price to be paid the minority shareholders:

Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's-length. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered or pursued. Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's-length is strong evidence that the transaction meets the test of fairness.\textsuperscript{176}

The \textit{Weinberger} court also decided that the Delaware block valuation formula was no longer the exclusive valuation methodology in Delaware and that any generally acceptable valuation technique could be utilized in determining fair value.\textsuperscript{177} Further, the court said that for future cases, appraisal would be the exclusive remedy in the absence of "fraud, misrepresentation, self dealing, deliberate waste of corporate assets, or gross and palpable overreaching . . . ."\textsuperscript{178}

Although Signal did not employ the type of independent negotiating structure suggested by the Delaware Supreme Court, the independent directors of UOP and a majority of the minority shareholders approved the transaction.\textsuperscript{179} As the court noted, however, neither the UOP independent directors

\textsuperscript{175} \textit{Id.} at 714.
\textsuperscript{176} \textit{Weinberger}, 457 A.2d at 709, n.7 (citations omitted).
\textsuperscript{177} \textit{Id.} at 712-13.
\textsuperscript{178} \textit{Id.} at 714.
\textsuperscript{179} \textit{Id.} at 707-08.
nor the public shareholders were fully informed.\textsuperscript{180} Further, as the court indicated, the only negotiation engaged in by Lehman Brothers was over the fee it would charge for essentially a weekend's worth of work.\textsuperscript{181} Lehman Brothers did not appear to be very vigorous in its attempt to value UOP.

The Delaware Supreme Court's decision in \textit{Kahn v. Lynch Communication Systems, Inc.} amplifies the application of the \textit{Weinberger} principle.\textsuperscript{182} In \textit{Lynch Communication Systems}, the court explained "[o]nce again, this court holds that the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness."\textsuperscript{183}

The court further stated that although the controlling shareholder initially has the burden of establishing entire fairness, if the transaction is approved by an "independent committee of directors or an informed majority of minority shareholders," the burden of proof on the fairness issue shifts to the shareholder-plaintiff.\textsuperscript{184} In this case, the court found that the "Court of Chancery's determination that the Independent Committee 'appropriately simulated a third-party transaction, where negotiations are conducted at arm's-length and there is no compulsion to reach an agreement,' [was] not supported by the record."\textsuperscript{185} Consequently, the controlling shareholder had the burden of proof on the entire fairness question.\textsuperscript{186}

On remand, the Chancery Court applied the entire fairness test with the burden on the controlling parent and found that the defendant proved the merger's fairness.\textsuperscript{187} Surprisingly, the Delaware Supreme Court affirmed despite evidence that

\textsuperscript{180} \textit{Id.} at 703.
\textsuperscript{181} \textit{Weinberger}, 457 A.2d at 706.
\textsuperscript{182} \textit{Kahn v. Lynch Communication Sys., Inc.}, 638 A.2d 1110 (Del. 1994).
\textsuperscript{183} \textit{Lynch Communication Sys.}, 638 A.2d at 1117 (citing \textit{Weinberger}, 452 A.2d at 710-11).
\textsuperscript{184} \textit{Id.}
\textsuperscript{185} \textit{Id.} at 1121.
\textsuperscript{186} \textit{Id.}
\textsuperscript{187} \textit{Kahn v. Lynch Communications Sys., Inc.}, No. 8748, 1995 WL 301403, at *2-3 (Del. Ch. Apr. 17, 1995).
the controlling parent forced the transaction on an independent negotiating committee.\(^{188}\)

This series of decisions in *Lynch Communication* shows that, when courts apply Delaware’s “entire fairness” test, it is first necessary to determine whether a special committee is indeed independent so that the burden of proof can be allocated. Then, it is necessary to apply close scrutiny on the entire fairness issue without regard to who has the burden of proof. This is at best a cumbersome process that, as shown in *Lynch Communication*, can produce strange results.

The defects in *Weinberger* and *Lynch Communication* would be cured by the adoption of a change of control board, which would in essence implement the suggestion in footnote 7 of the *Weinberger* decision, which proposes a “wholly independent board of directors acting upon the matter before them.”\(^{189}\)

6. **Summary of Current Delaware Corporate Governance Rules for Mergers and Acquisitions**

The following table summarizes the current Delaware corporate law governance rules for mergers and acquisitions:


\(^{189}\) Weinberger v. UOP, Inc., 457 A.2d 701, 709-10 n.7 (Del. 1983).
## Summary of Current Law Governance Rules For Mergers and Acquisitions

<table>
<thead>
<tr>
<th>TC</th>
<th>Management Buyouts</th>
<th>Defensive Tactics</th>
<th>Freezeouts</th>
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<tr>
<td>Arm's Length Mergers and Acquisitions</td>
<td>Entire fairness test applies with burden on the interested shareholders, unless an independent committee is utilized. See Dairy Mart. However, if directors negotiating transaction for TC are completely independent of buyout group, the BJR may apply. See RJR Nabisco, Inc. Shareholders' Litigation.</td>
<td>Permissible if TC's BD has reasonable grounds for believing there is a threat to TC, and the response to the threat posed is reasonable. See Unocal. Response cannot be coercive or preclusive and must be within a range of reasonableness. See Unitrin. The burden is on TC's BD. If it becomes clear that TC is for sale and under certain other circumstances, TC must be sold in a fair auction. See Revlon.</td>
<td>Entire fairness test applies with burden on controlling shareholder, unless an independent committee is utilized, in which case the burden is on the plaintiff. See Lynch Communication Systems.</td>
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TC = Target Corporation  
BD = Board of Directors  
BJR = Business Judgment Rule  
¶ = Plaintiff
7. Economic Effects in the Above Conflicts and in the Merger and Acquisition Market Place Generally

In several of the above cases, if the courts had not intervened, the targets' shareholders would have received substantially less than fair value for the shares they owned. This is true even though in each case the acquiror proposed to pay a price that was substantially more than the pre-acquisition trading price of the target's stock in regular market conditions. The adoption of the change of control board concept should ensure that in all cases the target's shareholders receive fair value for their shares.

Many economic studies have examined the price effects of merger and acquisition activity on both targets and acquirors. In general, the studies have found that target shareholders receive substantial premiums and that acquiror shareholders experience near zero returns. Professor Roberta Romano summarizes the evidence on targets as follows:

[A]cquisitions generate substantial gains to target company shareholders. All studies find that target firms experience statistically significant positive stock price responses to the announcement of takeover attempts or merger agreements. On average, there is a 20% increase over the pre-announcement market price for mergers and a 30% increase for tender offers in the period around the takeover announcement. Abnormal returns in going-private transactions (leveraged buyouts) are of a similar magnitude, ranging across studies between 20% and 37%. Without question the announcement of a bid is good news for target shareholders.190

Professor Romano summarizes the evidence on acquirors as follows: "[t]he data are more ambiguous, however, concerning acquiring firms' returns. Depending on the sample and time

period, acquirors experience positive, negative, or zero abnormal returns on a bid’s announcement and completion.\(^{191}\)

One might deduce from the economic evidence that target shareholders are generally receiving fair treatment in mergers and acquisitions and, therefore, a change of control board concept is not needed. This is the wrong conclusion for several reasons. First, even though target shareholders may on average benefit from mergers and acquisitions, the illustrative cases indicate that there is a real possibility that such shareholders may not benefit as much as they should. Second, the economic studies do not focus on those mergers and acquisitions that never occur because of the intransigence of the target’s board and the unwillingness of bidders to push the point. Adoption of the change of control board concept will ensure that acquirors get a fair hearing without unnecessary roadblocks. Thus, the change of control board concept should increase the economic efficiency of the market for corporate control.

One aspect of the drag on economic efficiency caused by the current system is illustrated by the factual background facing the Delaware Chancery court in \textit{Chesapeake Corp. v. Shore}.\(^{192}\) In this case, Shorewood, a publicly traded Delaware corporation, made an offer for Chesapeake, a publicly traded Virginia corporation.\(^{193}\) The offer was at a premium of 41% over the pre-bid trading price of Chesapeake’s shares.\(^{194}\) Chesapeake had a continuing director or “dead-hand” poison pill, which is redeemable only by the directors of the target at the time of an offer or by the director’s designees.\(^{195}\) This type of pill is permissible in Virginia and other states, such as Georgia\(^{196}\) that have pill validation statutes, but is not permissible in Delaware.\(^{197}\) As the court explained, Chesapeake’s dead-hand pill

\(^{191}\) \textit{Id.} at 123.


\(^{194}\) \textit{Id.}

\(^{195}\) \textit{Id.} at *20-21.

\(^{196}\) See, \textit{e.g.}, \textit{Invacare Corp. v. Healthdyne Tech., Inc.}, 968 F. Supp. 1578, 1580 (N.D. Ga. 1997).

\(^{197}\) See, \textit{e.g.}, \textit{Quickturn Design Sys., Inc. v. Shapiro}, 721 A.2d 1281 (Del. 1998).
and staggered board provided "iron-clad defenses." Chesapeake's board rejected Shorewood's offer and then made a counter offer for Shorewood at a 40% premium. Shorewood's board took various defensive measures, which the court held, inter alia, did not satisfy the Unocal test. Thus, the court's decision made Shorewood more susceptible to Chesapeake's offer. This case illustrates that under our current federal system, companies incorporated in states with pill validation statutes like those in Virginia and Georgia can be made takeover proof if the boards so decide, whereas companies in Delaware and in other states that follow Delaware law cannot be made takeover proof. Economic efficiency is obviously deterred by this system that permits, for example, a Virginia corporation to takeover a Delaware corporation in a hostile offer, but prevents a Delaware corporation from taking over a Virginia corporation in a hostile transaction.

Third, the adoption of a change of control board concept should increase the number of transactions in which targets are disposed of in fair auctions and, therefore, should increase the consideration paid to the shareholders of such targets. This conclusion follows from the observation of Professor Romano that premiums are higher in tender offers than in negotiated mergers.

Finally, each of the above cases illustrates that in the change of control context there is often no effective separation of what Professors Fama and Jensen call "decision management" and "decision control." Decision management involves "initiation," that is, the "generation of proposals for resource utilization and structuring of contracts," and "implementation," that is, the "execution of ratified decisions." Decision control involves "ratification," that is, the "choice of the decision initiatives to be implemented," and "monitoring," that

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199 Id. at *21-22.
200 Romano, supra note 190, at 122.
202 Id. at 303.
is, "measurement of the performance of decision agents and implementation of rewards." Because of the collective action problem facing shareholders in publicly held corporations, the boards of such companies, even if the boards have a majority of disinterested directors, effectively perform the functions of both decision management and decision control. Professors Fama and Jensen explain: "Without separation of decision management and decision control, residual claimants [e.g., public shareholders] have little protection against opportunistic actions of decision agents, and this lowers the value of unrestricted residual claims." They further explain that the "agency problems of diffuse decision management can . . . be reduced by separating the management (initiation and implementation) and control (ratification and monitoring) of decisions." The proposal here for a change of control board is consistent with the observation of Professors Fama and Jensen that "[e]ffective separation of top-level decision management and control means that outside directors have incentives to carry out their tasks and do not collude with managers to expropriate residual claimants . . . . [O]utside directors have incentives to develop reputations as experts in decision control." Adoption of this proposal would insure that the change of control process is presided over by real outside directors.

C. The ALI's Governance Rules for Mergers and Acquisitions

1. Introduction

The Corporate Governance Project sets forth governance rules for, inter alia, the four transactions addressed here: arm's-length mergers and acquisitions; management buyouts; defensive tactics in tender offers; and freezeouts. The ALI's treatment of each of these transactions is discussed in the following sections.

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203 Id.
204 Id. at 305-06.
205 Id. at 308.
206 Id. at 325.
207 See CORPORATE GOVERNANCE PROJECT, supra note 2.
2. Arm's-length Mergers and Acquisitions

Section 6.01 of the Corporate Governance Project governs the actions of a target's board in all forms of arm's-length mergers and acquisitions.\(^{208}\) This provision authorizes a target's board "in the exercise of its business judgment . . . [to] 'approve, reject or decline to consider a proposal'" to engage in a merger or acquisition (i.e., a transaction in control).\(^{209}\) Specific rules regarding the board's duty of care and the protection afforded by the business judgment rule are set forth in section 4.01.\(^{210}\) The rules in section 4.01 apply generally and to arm's-length mergers and acquisitions under section 6.01. Thus, section 6.01 gives a target's board wide latitude in responding to an arm's-length merger or acquisition proposal, and the board's decisions will be protected by the business judgment rule in section 4.01(c) as long as (1) the director's business judgment is made in good faith, and (2) the director (a) is not interested in the transaction, (b) "is informed with respect to the subject of the business judgment," and (c) "rationally believes that the business judgment is in the best interests of the corporation."\(^{211}\) The business judgment rule also protects the directors of an acquiring corporation.\(^{212}\)

Under section 7.24, appraisal by the court that hears the dispute is the exclusive remedy a shareholder has for challenging an arm's-length transaction.\(^{213}\) As a practical matter, however, appraisal proceedings will be rare, because under section 7.22(b), in an arm's-length transaction, the price accepted by the target's board is presumed to be fair value "unless the plaintiff can prove otherwise by clear and convincing evidence."\(^{214}\) Thus, the appraisal rules for arm's-length transactions are structured to discourage the use of appraisal proceedings.

\(^{208}\) See CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.01(a).
\(^{209}\) See Thompson, supra note 2, at 169. (quoting CORPORATE GOVERNANCE PROJECT, § 6.01(a)).
\(^{210}\) See Thompson, supra note 2, at 157.
\(^{211}\) See CORPORATE GOVERNANCE PROJECT, supra note 2, § 4.01(c).
\(^{212}\) See Thompson, supra note 2, at 165.
\(^{213}\) See CORPORATE GOVERNANCE PROJECT, supra note 2, § 7.24.
\(^{214}\) See CORPORATE GOVERNANCE PROJECT, supra note 2, § 7.22(b).
3. Management Buyouts

Section 5.15 of the Gouverneur Governance Project governs management buyout transactions, which are mergers and acquisitions in which the directors or principal executive officers of the target have an interest in the acquiring vehicle. In these transactions, the general rule is that "interested directors/executives have the burden of proving the transaction is fair to the target's shareholders." However, if the following four conditions are satisfied, the challenging party has the burden of proving waste of corporate assets. The conditions are: (1) public disclosure of the proposed transaction must be made, (2) responsible potential bidders must be provided with the relevant information and must be "given a reasonable opportunity to submit a competing proposal" (that is, the transaction must be market tested), (3) the transaction must be approved by disinterested directors, and (4) the transaction must be approved, or the tender offer accepted, by disinterested shareholders.

Although appraisal is not the exclusive remedy for dissenting shareholders in a management buyout, if the transaction is market-tested and approved by disinterested directors and shareholders as specified in section 5.15(b), it is likely that the accepted price would constitute fair value. Consequently, if such a mechanism is utilized, it is unlikely that there would be a challenge either on the grounds of waste of corporate assets or in an appraisal proceeding. Thus, appraisal can effectively be avoided in management buyouts by using market test procedures and securing the approval of disinterested directors and shareholders.

If these market test and disinterested director/shareholder procedures are followed, the practical result is the same as that reached in arm's-length transactions governed by section 6.01 and the business judgment rule of section 4.01(c). However, if

215 See Thompson, supra note 2, at 206.
216 Thompson, supra note 2, at 207.
217 See Thompson, supra note 2, at 207-08.
218 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 5.15(b).
219 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 5.15(c).
this approach were adopted, there would likely be substantial litigation over whether the directors were truly disinterested, the transaction was adequately market tested, and the shareholders were adequately informed. These questions would not likely arise with a change of control board.

4. Defensive Tactics in Tender Offers

Section 6.02 of the Corporate Governance Project governs actions of a target's board that have the "foreseeable effect of blocking an unsolicited tender offer." The directors may take such defensive action as long as the action is a "reasonable response to the offer."

"In [determining] whether [an] action is a reasonable response to [an] offer," the target's board may take into account all relevant factors including "questions of legality" and whether the offer, if successful, would "threaten the corporation's essential economic prospects." Further, the target's board may "have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of the shareholders."

Under Section 6.02(c), the challenging party has the burden of proving "that the board's action is an unreasonable response to the offer." Thus, although the Corporate Governance Project explains that the standards in section 6.02 are "intended to be consistent" with the enhanced or intermediate standard of review set forth in the Delaware Supreme Court's decision in Unocal, the burden under section 6.02 is on the challenging party. This should be contrasted with the Unocal decision, which places the burden on the target's direc-

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220 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.02(a).
221 See CORPORATE GOVERNANCE PROJECT, supra note 2; see generally Thompson, supra note 2, at 224-26.
222 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.02(b)(1).
223 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.02(b)(2).
224 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.02(c).
225 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.02 cmt. a; see also supra notes 67-73 and accompanying text.
226 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.02, cmt. a.
tors to prove that their action in blocking a tender offer was a reasonable response.\textsuperscript{227}

Thus, section 6.02 sets out a standard of reasonableness that is higher than the "rationally believes" standard of the business judgment rule in section 4.01(c) that applies in arm's-length mergers and acquisitions under section 6.01.\textsuperscript{228} Under the business judgment rule, the decision of the target's directors need not be a reasonable response.\textsuperscript{229} As long as the directors act in good faith, are not interested, and are informed, the business judgment rule applies if they "rationally believe" that their business judgment is in the best interest of the corporation.\textsuperscript{230} The Corporate Governance Project explains that the "rationally believes" test is "intended to afford directors and officers wide latitude when making business decisions" and that "[s]ound public policy dictates that directors and officers be given greater protection than . . . a 'reasonableness' test would afford."\textsuperscript{231} Even though section 6.02 adopts a reasonableness standard, the Corporate Governance Project makes clear that a target's directors are given wide latitude in responding to a hostile tender offer.\textsuperscript{232}

The Corporate Governance Project provides, however, that "there will be [some] sets of facts where the board will not be able to block the tender offer and satisfy the requirements of § 6.02."\textsuperscript{233} Unfortunately, the Corporate Governance Project does not give an illustration of such a set of facts. Also, the Corporate Governance Project says that under the Section 6.02 standard, a court faced with the facts in the Paramount case would likely reach the result the Supreme Court of Delaware reached in that case.\textsuperscript{234} This would likely not be the result with a change of control board. Because the burden is on the challenging party rather than on the target's board, as under

\textsuperscript{227} See CORPORATE GOVERNANCE PROJECT, supra note 2.
\textsuperscript{228} See CORPORATE GOVERNANCE PROJECT, supra note 2.
\textsuperscript{229} See CORPORATE GOVERNANCE PROJECT, supra note 2, § 4.01 cmt. c.
\textsuperscript{230} See CORPORATE GOVERNANCE PROJECT, supra note 2.
\textsuperscript{231} See CORPORATE GOVERNANCE PROJECT, supra note 2, § 4.01 cmts. e. & f.
\textsuperscript{232} See CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.02 cmt. c(8).
\textsuperscript{233} See CORPORATE GOVERNANCE PROJECT, supra note 2.
\textsuperscript{234} See CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.02, rptr. n.3.
the Delaware Unocal test, adoption of the section 6.02 standard would likely make it more difficult to challenge the actions of an entrenched board.

5. Freezeouts

The Corporate Governance Project divides freezeout transactions into those in which the controlling shareholder does not have sufficient voting control to unilaterally effectuate the transaction (i.e., non-majority control freezeouts) and those in which such unilateral voting power exists, as is the case with short form-mergers (i.e., majority control freezeouts).235

Non-majority control freezeouts are governed by section 5.10.236 Section 5.10(a) provides that a controlling shareholder satisfies its duty of fair dealing if either "(1) the transaction is fair to [the target] when entered into;" or (2) after disclosure, the transaction is approved by disinterested shareholders and does not constitute a waste of corporate assets.237

Under section 5.10(b), if disclosure is made and the transaction is approved by disinterested directors or disinterested shareholders, the challenging party has the burden of proving a waste of corporate assets.238 If this procedure is not followed, the controlling shareholder has the burden of proving the transaction is fair.239

Although appraisal is not the exclusive remedy in non-majority control freezeouts, if the disclosure and disinterested director/shareholder procedures are followed as a practical matter, the consideration paid in the transaction should constitute fair value and the transaction should not constitute a waste of corporate assets.

Majority control freezeouts are subject to section 5.10 unless the following four conditions of section 7.25 are satisfied.240 First, the directors who approve the transaction must

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235 See Corporate Governance Project, supra note 2, §§ 5.10, 7.25.
236 See Corporate Governance Project, supra note 2, § 5.10.
237 See Corporate Governance Project, supra note 2, § 5.01(a).
238 See Corporate Governance Project, supra note 2, § 5.01(b).
239 See Corporate Governance Project, supra note 2.
240 See Corporate Governance Project, supra note 2, § 7.25 cmt. c.
have an "adequate basis, grounded on substantial objective evidence, for believing that the consideration offered to the minority shareholders... constitutes fair value for their shares."241 Second, full disclosure must be made to minority shareholders.242 Third, the transaction must be approved pursuant to state law and the "corporation's charter documents."243 Finally, dissenting shareholders must have an appraisal right.244 If these four conditions are met, appraisal is the exclusive remedy.245

Under Section 7.25(b), the controlling shareholder has the burden of proving compliance with these four conditions, unless the transaction was approved by disinterested directors and disinterested shareholders.246 In such a case, the burden is on the challenging party.247

In summary, if disinterested directors negotiate with the controlling shareholder concerning the price of the transaction and the parties agree on a price that is approved or ratified by disinterested shareholders, then the burden is on the challenging party to establish that one of the four conditions is not satisfied. If the challenging party meets this burden, appraisal is not the exclusive remedy.

As a practical matter, if an independent negotiating structure is utilized, the controlling shareholder will have an "adequate basis" for believing that the price constitutes fair value, and assuming the other conditions are satisfied (which will normally be the case), appraisal will be the exclusive remedy. Furthermore, the price set by the independent negotiating structure would normally be found to constitute fair value in an appraisal proceeding. However, under this approach disputes will undoubtedly arise concerning whether the negotiating structure is indeed independent; this would not be an issue with a change of control board.

241 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 7.25(a)(1).
242 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 7.25(a)(2).
243 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 7.25(a)(3).
244 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 7.25(a)(4).
245 See CORPORATE GOVERNANCE PROJECT, supra note 2.
246 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 7.25(b).
247 See CORPORATE GOVERNANCE PROJECT, supra note 2.
6. Summary of ALI's Governance Rules for Mergers and Acquisitions

The following table summarizes the above Merger and Acquisition Rules:

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<tr>
<td>§ 6.01 Arm's Length Mergers &amp; Acquisitions</td>
<td>§ 5.15 Management Buyouts</td>
<td>§ 6.02 Defensive Tactics</td>
<td>§ 5.10 Non-Majority Control Freezeouts</td>
<td>§ 7.25 Majority Control Freezeouts</td>
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<tr>
<td>(a) 6.01: Wide latitude for TC's* BD** to act</td>
<td>(a) 5.15: Interested Directors/Executives have burden of proving transaction is fair unless 5.15(b) applies.</td>
<td>(a) 6.02: Target's BD may take action having foreseeable effect of blocking a tender offer if such action is reasonable response to the offer.</td>
<td>(a) 5.10(a): Controlling shareholder satisfies duty of fair dealing if either (1) transaction is fair, or (2) after disclosure transaction is approved by disinterested shareholders and transaction is not a waste.</td>
<td>(a) 7.25: Subject to 5.10 unless:</td>
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<td>§ 7.25 Majority Control Freezouts</td>
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<tr>
<td>(b) 4.01: Duty of Care</td>
<td>(b) Under 5.15(b): has burden of proving waste if: (1) Public disclosure, (2) Market tested, (3) Approved by disinterested directors, and (4) Transaction approved or tender offer accepted by disinterested shareholders.</td>
<td>(b) Reasonable is higher standard than rational standard under BJR.</td>
<td>(b) 5.10(b): burden on if disclosure and transaction approved by disinterested directors or shareholders. must prove waste.</td>
<td>(b) 7.25 applies and appraisal is exclusive remedy. See (c).</td>
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<td>(c) 4.01(c): BJR*** Protection if: (1) Good faith, (2) Not interested, (3) Informed, (4) Rationally believes in best interest of the corporation.</td>
<td>(c) Appraisal not exclusive remedy. However, if 5.15(b) followed likely effect no waste and merger price = fair value.</td>
<td>(c) TC's BD can consider whether offer threatens TC's essential economic prospects and may consider other constituencies as long as such action does not significantly disfavor long-term interest of the shareholders.</td>
<td>(c) Appraisal not exclusive remedy.</td>
<td>(c) Under 7.25(1) directors must have adequate basis for concluding price = fair value (2) disclosure, (3) procedural approvals, (4) dissenting shareholder must have appraisal right.</td>
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<td>(d) 7.24: Appraisal is exclusive remedy.</td>
<td>(d) Burden of proving unreasonableness on challenging party.</td>
<td>(d) But if disclosure and disinterested, no waste and price = fair value.</td>
<td>(d) Under 7.25(b) burden on parent unless approved by disinterested directors and disinterested shareholders.</td>
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e) 7.22: Merg-
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<td>(e) If not 7.25 then must meet 5.10.</td>
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*TC = Target Corporation
** BD = Board of Directors
*** BJR = Business Judgment Rule
**** q = Plaintiff
7. Comment on the ALI's Approach

The ALI's rules are quite complex; however, the bottom line is that if disinterested directors act in each of the transactions, courts will find the amount paid to be fair. This is, in essence, a disinterested director approach, which, for the reasons outlined below, is fundamentally flawed. Also, the ALI's approach to defensive tactics in tender offers is even more protective of the target's directors than is Delaware law with its *Unocal* standard, because the burden of proof is on the plaintiff, instead of the director, as would be the case under the *Unocal* standard.²⁴⁸

For these reasons, the change of control concept is superior to the ALI's approach. However, the ALI's formulation of the business judgment rule in section 4.01 and its basic formulation of the standard governing tender offers in section 6.02 is adopted here under the proposed change of control board standard.²⁴⁹

III. OPERATION OF CHANGE OF CONTROL BOARD

A. Introduction

This section discusses the operational rules governing the change of control board. The specific statutory language is set forth in Proposed Section 14A to the Securities Exchange Act of 1934, which is set out in the Appendix.²⁵⁰ Also, this section discusses the effects on certain collateral provisions of the 1934 Act and the Internal Revenue Code.

B. Corporations Subject to the Rules

Unless public shareholders vote to elect-out of Proposed Section 14A (an option available under the proposed law), Proposed Section 14A applies to domestic public corporations with respect to which a trigger event occurs.²⁵¹ Such public corporations are referred to in Proposed Section 14A(a) as "affected

²⁴⁸ See supra notes 72, 226 and accompanying text.
²⁴⁹ See CORPORATE GOVERNANCE PROJECT, supra note 2, §§ 4.01, 6.02.
²⁵⁰ See infra app. § 14A.
²⁵¹ See infra app. § 14A(a).
A public corporation is any corporate issuer that satisfies the asset and shareholder test of § 12(g) of the 1934 Act. Under § 12(g)(1), every issuer engaged in interstate commerce or in an activity affecting interstate commerce or whose securities are traded in interstate commerce, is required to register such securities with the SEC, provided the issuer has total assets exceeding $10 million and equity securities held of record by five hundred or more persons. Although under § 12(g), issuers that are not corporations may be required to register, the control board concept applies to only domestic corporate issuers that have more than $10 million in assets and at least 500 shareholders.

Five types of trigger events are specified in Proposed Section 14A(b). Section 14A(b)(1) encompasses all forms of arm's-length consensual mergers and acquisitions proposed to a target's board, including arm's-length mergers, management buyouts, and freezeouts. This concept, therefore, includes proposed direct or subsidiary mergers that include target acquisitions and proposals to acquire substantially all of the target's assets.

Proposed Section 14A(b)(2) encompasses proposed mergers or acquisitions that are initiated by the target's management—such as occurred in Van Gorkom.

Proposed Section 14A(b)(3) encompasses hostile tender offers for public corporations. Proposed Section 14A(b)(4) involves transactions in which a Schedule 13D, indicating an acquisition of more than 5% of the issuer's stock, is filed with respect to a public corporation, provided the purpose of the
acquisition is, or may be, to effectuate an acquisition of the issuer. Thus, if the Schedule 13D indicates that the acquiror has a bona fide potential change of control purpose, then a trigger event has occurred.

Proposed Section 14A(b)(5) encompasses situations in which a public acquiring corporation acquires the stock or assets of another corporation in exchange for stock of the acquiring corporation that exceeds 50% of the acquiring corporation’s outstanding stock after the acquisition. Thus, this type of trigger event involves a so-called “upside-down” acquisition in which a small corporation acquires, in exchange for its stock, the stock or assets of a large corporation. In such cases, the acquiring corporation is deemed to have experienced a trigger event. Thus, Proposed Section 14A(b)(5), in essence, would codify one aspect of the *de facto* merger doctrine.

In addition to the trigger event under Proposed Section 14A(b)(5) for the public acquiring corporation, a trigger event will also occur under Proposed Section 14A(b)(1) with respect to the target if it is a public corporation. Thus, in such cases both the public acquiror and the public target are affected issuers. This would be the case, for example, in a situation such as the proposed original merger between Time Inc. and Warner Communications, Inc. In that transaction, it was proposed that Time acquire Warner in a reverse subsidiary merger in which the shareholders of Warner would have owned approximately 62% of Time after the merger, and Warner would have become a wholly-owned subsidiary of Time. Under Proposed Section 14A(b)(1), a trigger event would have occurred with respect to Warner since Time proposed a merger between the two companies. Also, under Proposed Section 14A(b)(5), a trigger event would have occurred with respect to Time since it was proposed that Time issue in the acquisition its stock amounting to in excess of 50% of Time’s outstanding shares

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261 See infra app. § 14A(b)(4).
262 See infra app. § 14A(b)(5).
263 See infra app. § 14A(b)(5) cmt. 1.
264 See infra app. §§ 14A(b)(1), (b)(5).
266 Paramount, 571 A.2d at 1141-49.
267 See infra app. § 14A(b)(1); Paramount, 571 A.2d at 1146.
after the transaction. Consequently, both Time and Warner would have been affected issuers under Proposed Section 14A(a), and, under Proposed Section 14A(c), which is discussed below, a change of control board would have been appointed with respect to each such corporation.

C. Change of Control Official

Upon the happening of a trigger event with respect to a public corporation, Proposed Section 14A(c)(1) imposes a duty on the target's board to petition the Change of Control Official for the appointment of a change of control board. Under Proposed Section 14A(c)(2), if the target's board does not promptly file such a petition either the SEC or a shareholder or shareholders owning at least 5% of the target's shares may file the petition instead.

Under Proposed Section 14A(d), the Change of Control Official is a non-political appointee of the SEC, and the appointee is not to "be identified with any particular change of control theory or ideology." A majority of the members of the Federal Reserve Board must concur in the appointment. This concurrence procedure should help ensure that the Change of Control Official is indeed non-political and does not have a particular philosophy regarding change of control transactions. The SEC may, if it deems appropriate, appoint Change of Control Officials for various sections of the country.

The Change of Control Official or Officials perform functions similar to those of a United States Trustee in a bankruptcy proceeding. The primary functions of the Change of Control Official are: (1) the identification of qualified persons willing to serve on a change of control board, and of qualified attorneys, investment bankers, and other merger and acquisition

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268 See infra app. § 14A(b)(5); Paramount, 571 A.2d at 1148.
269 See infra app. § 14A(c).
270 See infra app. § 14A(c)(1).
271 See infra app. § 14A(c)(2).
272 See infra app. § 14A(d)(1).
273 See infra app. § 14A(d)(1).
274 See infra app. § 14A(d)(1).
specialists willing to provide advice to change of control boards, (2) the appointment of change of control boards, and (3) consulting with change of control boards regarding the hiring by such boards of professional advisors.\textsuperscript{276} All other duties would be governed by SEC rules and regulations.

Proposed Section 14A(e) sets forth the rules regarding the appointment of the members of a change of control board.\textsuperscript{277} The Change of Control Official must make such appointments promptly after the receipt of a petition.\textsuperscript{278} The change of control board is to consist of three members unless the Change of Control Official decides that, under the circumstances, it is appropriate to appoint more than three.\textsuperscript{279} No more than five members may be appointed.\textsuperscript{280}

In making the appointments, the Change of Control Official must first insure that each member is not interested in the proposed transaction.\textsuperscript{281} The determination of whether a member is interested is to be made pursuant to rules to be promulgated by the SEC.\textsuperscript{282} It is contemplated that such rules will be broader than the rules under current law and the provisions of the Corporate Governance Project for determining whether a party is interested in the transaction.

In making the selections, the Change of Control Official should also give consideration to the proposed member’s experience in dealing with change of control transactions, and, in appropriate cases, should give consideration to the prospective member’s knowledge of the particular industry.\textsuperscript{283} This selection process should maximize the possibility that the members of a change of control board will be free of any possible conflict and will have the experience needed to do an effective job. Further, the Change of Control Official should be satisfied that each member will: (1) act in good faith, (2) make a proper in-

\textsuperscript{276} See infra app. § 14A(d)(2). This identification process should be an ongoing process, so that once a change of control takes place, appointment of the change of control board and its advisors could be made from a list of individuals who have already been identified.

\textsuperscript{277} See infra app. § 14A(e).

\textsuperscript{278} See infra app. § 14A(e).

\textsuperscript{279} See infra app. § 14A(e).

\textsuperscript{280} See infra app. § 14A(e).

\textsuperscript{281} See infra app. § 14A(e).

\textsuperscript{282} See infra app. § 14A(e).

\textsuperscript{283} See infra app. § 14A(e).
quiry, and (3) rationally believe that any decision made is in the best interest of the corporation. Thus, the Change of Control Official will be required to make an *ex ante* judgment that each member of the change of control board will satisfy the duty of care standard and will be protected by the business judgment rule set forth in Proposed Section 14A(i).

The Change of Control Official may, in appropriate circumstances, appoint to the change of control board one member (and no more than one) of the target's regular board who is otherwise qualified to serve. The Change of Control Official should make every effort to make such an appointment because such a member could provide continuity and helpful insights. However, a member of the regular board should not be appointed unless the Change of Control Official is convinced that the person clearly is disinterested.

It should be anticipated that in most cases the members of a change of control board would reside in the geographic area in which the affected issuer has its headquarters, thereby facilitating meetings of the change of control board and minimizing travel delay and costs.

Once appointed, the members of the change of control board will continue to serve until resignation by the member or dissolution of the board.

**D. Responsibilities and Authority of Change of Control Board**

1. *In General*

Proposed Section 14A(f) sets out the responsibilities and authority of the members of a change of control board. In essence, such boards, acting by a majority vote, have full power over all matters relating to a proposed change of control transaction involving the affected issuer.

First, the change of control board has the power to decide whether to consider, accept, or reject a proposal to enter into a

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284 See infra app. § 14A(e).
285 See infra app. § 14A(i)(3)-(4).
286 See infra app. § 14A(e).
287 See infra app. § 14A(e).
288 See infra app. § 14A(e).
289 See infra app. § 14A(e).
290 See infra app. § 14A(e).
291 See infra app. § 14A(f)(1) cmt. 1.
merger or acquisition. This power is similar to that specified in section 6.01 of the Corporate Governance Project for arm’s-length mergers and acquisitions.

Second, such boards have the power to implement defensive tactics that may have the foreseeable effect of blocking the offer. This power is similar to the principle set out in section 6.02 of the Corporate Governance Project relating to hostile tender offers. Such tactics include the issuance of a poison pill, provided that state law or the corporation’s charter authorizes any such action. Thus, the change of control board may not take any action that the corporation’s regular board would be prohibited from taking by state law or the charter documents.

The current state of the empirical evidence bearing on the efficacy of the poison pill would support granting the change of control board the power to use a pill as it deems appropriate. For example, the recent works of Professor Coates challenge the conclusions reached by many academics on the basis of event studies that poison pills harm a target’s shareholders. On the other hand, he also criticizes premium studies that many have relied on as support for the view that pills are beneficial to a target’s shareholders. His analysis led to the following principal conclusions: (1) “Institutional shareholders should be aware of the fact that half the traditional academic case (at least) against defenses stands on shaky ground...” (2) “Boards... should not be permitted to rely without caveat on pill premium studies to support a decision to adopt a pill at a given point in time,” and (3) “Delaware courts... should

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292 See infra app. § 14A(f)(1)(i).
293 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.01.
295 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.02.
296 See infra app. § 14A(f)(3).
297 See infra app. § 14A(f)(3).
299 Coates, Empirical Evidence, supra note 298, at 785.
300 Coates, Empirical Evidence, supra note 298, at 797; see also Coates, Takeover Defenses, supra note 298, at 338.
301 Coates, Empirical Evidence, supra note 298, at 797; see also Coates, Take-
take some comfort from the fact that they resisted strong academic arguments . . . to push them to dramatically repudiate pills and other structural defenses."\(^{302}\)

While a change of control board would have the power to issue a traditional pill, it would have no reason to issue a continuing director or deadhand pill like the ones found invalid under Delaware law in *Carmody v. Toll Brothers*\(^{303}\) but valid under Georgia law in the *Invacare Corp. v. Healthdyne Technologies, Inc.*\(^{304}\). Also, a change of control board would have no reason to issue a delayed redemption pill like the one found invalid under Delaware law in *Quickturn Design Systems, Inc. v. Shapiro*.\(^{305}\) In this type of pill, the replacement board appointed after a successful proxy contest is prohibited from redeeming the target’s pill for a specified period. Thus, these issues concerning the validity of attempts by boards to deter proxy contests by restricting the ability of a new board to redeem a pill would not be of concern under the change of control provisions.

Third, the change of control board has complete responsibility and authority over the preparation of proxy statements, information statements and other disclosure documents relating to the change of control transaction.\(^{306}\) The change of control board can in appropriate circumstances delegate these and other matters to the target’s officers. The change of control board has the authority to negotiate with antitrust and other regulatory authorities and to make divestiture decisions that may be required by such authorities. The change of control board would, however, consult closely with the regular board before making any divestiture.

Fourth, such board has control over the preparation of the target’s response to a tender offer on Schedule 14D-9 under the 1934 Act.\(^{307}\)

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\(^{302}\) Over Defenses, supra note 298, at 338.

\(^{303}\) Coates, Empirical Evidence, supra note 298, at 797; see also Coates, Takeover Over Defenses, supra note 298, at 338.

\(^{304}\) 723 A.2d 1180 (Del. Ch. 1998).


\(^{306}\) 761 A.2d 1281 (Del. 1998).

\(^{307}\) See infra app. § 14A(f)(1)(i).
Fifth, such boards have the authority to cause the corporation to make "golden parachute" and similar severance payments to key employees of the target.\textsuperscript{308} The regular board would have no power over such payments. The change of control board could thus take appropriate steps to ensure the continued services of key employees.

Sixth, such boards may cause the corporation to redeem its stock at a premium in a "greenmail" transaction.\textsuperscript{309} The corporation’s regular board would have control over redemption programs that are not connected with a potential change of control transaction.

Seventh, change of control boards have the authority to cause the corporation to enter into various types of lock-up agreements, such as stock options and no shops, to protect a negotiated merger or acquisition transaction.\textsuperscript{310} Stock options give the acquiror the right to buy stock in the target at premerger (bargain) prices if a third party acquires the target, and no shops prevent the target’s board from seeking a better deal from a third party, subject to certain fiduciary obligations to the target’s shareholders.

Eighth, the change of control board may cause the corporation to pay various types of fees to induce a potential acquiror to enter the bidding, such as "hello fees" and "goodbye (i.e., termination) fees."\textsuperscript{311}

The law in Delaware governing deal protection devices like stock options, termination fees, and no shops is not yet settled.\textsuperscript{312} For example, in \textit{Phelps Dodge Corp. v. Cyprus Amax Minerals Co.},\textsuperscript{313} Chancellor Chandler expressed the view that "no talk" provisions are "troubling" and may amount to "willful blindness."\textsuperscript{314} He further observed that the termination fee in that case "probably stretches the definition [of range of reasonableness] beyond its breaking point."\textsuperscript{315} Along the same lines, Vice Chancellor Strine in \textit{ACE Limited v. Capital Re Corpora-
tion found that the no talk there was likely invalid. He reasoned that "[w]hen corporate boards assent to provisions in merger agreements that have the primary purpose of acting as a defensive barrier to other transactions not sought out by the board, some of the concerns that animated the Unocal standard of review might be implicated." On the other hand, in In re IXC Communications, Inc. Shareholders Litigation v. Cincinnati Bell, Inc. Vice Chancellor Steele applied the business judgment rule in validating a termination fee, a stock option and a no shop that were not "defensive mechanisms instituted to respond to a perceived threat to a potential acquiror." The standard of review for a change of control board that employed any of these deal protection devices would be the business judgment rule set out in Proposed Section 14A(i)(4), which is discussed in Section III.E. below.

The change of control board may, with the approval of the Change of Control Official, hire its own independent attorney, investment banker, or any other professionals necessary for it to carry out its business. Since such professionals will be hired directly by the change of control board, they should be free of the conflicts that have infected professionals in the acquisitions detailed by Chancellor Allen.

Proposed Section 14A(f)(4) requires the corporation's regular board to cooperate fully with the change of control board. It is anticipated that the change of control board will, in appropriate cases, consult extensively with the target's regular board concerning the merits of the proposed merger or acquisition. Also, the change of control board may consult with certain influential shareholders of the target company.

If the regular board does not cooperate, the change of control board may petition a court to suspend the regular board and transfer all of its responsibilities to the change of control board. The members of a change of control board are not to

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316 747 A.2d (Del. Ch. 1999).
317 ACE Ltd., 747 A.2d at 108.
319 Cincinnati Bell, 1999 Del. Ch. LEXIS 210 at *29.
320 See infra app. § 14A(f)(2).
321 See infra Part V.
322 See infra app. § 14A(f)(4).
323 See infra app. § 14A(b)-(4).
be considered as governmental employees for any purpose, such as the Administrative Procedure Act or the Freedom of Information Act.

The regular board would continue to make decisions for the target that are in the ordinary course of the target’s business, and the regular board should seek the approval from the change of control board for any major decision, such as the sale or acquisition of a major line of business. The SEC should promulgate rules delineating the division of responsibilities between the two boards. Such rules will likely be similar to standard provisions found in acquisition agreements in which the target agrees that “[d]uring the period from the date of the agreement and continuing until the [closing of the acquisition]” it will “carry on [its] business in the usual, regular, and ordinary course . . . .” 3

This dual board structure is similar to but by no means the same as the dual board structure that applies to publicly held German corporations, 325 which are required to have a management board and a supervisory board. The supervisory board appoints the management board and “plays a monitoring role somewhat similar to that played by outside directors on a unitary board.” 326 The supervisory board also has a role in “helping to develop the long-term corporate strategy and finance . . . .” 327 and “the articles of the supervisory board may determine that specific types of transactions may be entered into only with the approval of the supervisory board.” 328

2. Compensation, Oversight, and Incentives For the Change of Control Board and Its Advisors

Pursuant to Proposed Section 14A(g), the members of a change of control board are to be compensated by the target on
a fee for services basis.\textsuperscript{329} The SEC is to promulgate rules concerning such compensation, including a periodically updated fee schedule.\textsuperscript{330} In developing these rules, the SEC is to take into consideration "such factors as the size of the parties, the complexity of the transaction and the level of fees that would be payable in the open market for comparable work for comparable companies."\textsuperscript{331} It is crucial that in both perception and reality members of a change of control board be compensated fairly for their services. The Change of Control Official will be charged with monitoring each change of control board to ensure that the board does not unreasonably extend its term.\textsuperscript{332} Further, the Change of Control Official is to develop methods and procedures for evaluating the performance of change of control boards for the purpose of determining whether members should be appointed to future change of control boards.\textsuperscript{333}

The combination of the interesting—if not fascinating—work performed by a change of control board, the fair compensation afforded their members, and the potential for appointment to change of control boards in the future, should be powerful incentives for members of a change of control board to perform their services diligently. It could be expected that a vigorous market for membership on change of control boards would develop, and it could also be expected that the most challenging assignments would go to those who have been most effective in discharging their responsibilities.

The costs of operating a change of control board may indeed be less than the costs of having a regular board supervise an acquisition. This is true for two reasons. First, a change of control board will generally consist of just three members; therefore, the affected issuer will not incur the substantial meeting fees that would normally be paid to its much larger regular board for multiple meetings during the course of a change of control transaction. Second, the members of the change of control board normally will reside in the same geographic area in which the affected issuer has its headquarters, thereby minimizing travel costs.

\textsuperscript{329} See infra app. § 14A(g).
\textsuperscript{330} See infra app. § 14A(g).
\textsuperscript{331} See infra app. § 14A(g).
\textsuperscript{332} See infra app. § 14A(d)(2).
\textsuperscript{333} See infra app. § 14A(d)(2).
Proposed Section 14A(h)(1) sets forth a fee for service compensation arrangement for the advisers to the change of control board.\textsuperscript{334} However, under Proposed Section 14A(h)(2), in appropriate circumstances and with the approval of the Change of Control Official, investment bankers who add significant value to the transaction may be compensated on a contingent fee basis.\textsuperscript{335} The SEC is to promulgate rules setting out general guidelines concerning contingent fees.\textsuperscript{336}

**E. Scope of Authority, Duty of Care, and Business Judgment Rule**

Proposed Section 14A(i) sets out the rules regarding: (1) the scope of authority a change of control board has in a merger and acquisition transaction, (2) the duty of care governing actions taken by a change of control board, and (3) the business judgment rule protecting the change of control board.\textsuperscript{337} These provisions are based on the analogous provisions of the Corporate Governance Project.\textsuperscript{338} One standard applies to all types of mergers and acquisitions. The multiple rules set out in the Corporate Governance Project for different types of mergers and acquisitions are not needed because of the experience and disinterestedness of members of a change of control board.

Proposed Section 14A(i)(1), which sets out the general scope of authority specified in sections 6.01 (arm's-length transactions) and 6.02(a) (tender offers) of the Corporate Governance Project, provides that a change of control board may, in the exercise of its business judgment, approve, reject, or decline to consider a proposal to the target to engage in a merger or acquisition transaction and may take an action, such as the issuance of a poison pill, "that has the foreseeable effect of blocking an unsolicited tender offer."\textsuperscript{339}

Proposed Section 14A(i)(2) authorizes the change of control board to consider the interests of constituencies other than shareholders with respect to which the target has a legitimate concern, if to do so would not significantly injure the long-term

\textsuperscript{334} See infra app. § 14A(h)(1).
\textsuperscript{335} See infra app. § 14A(h)(2).
\textsuperscript{336} See infra app. § 14A(h)(2).
\textsuperscript{337} See infra app. § 14A(i).
\textsuperscript{338} See infra app. § 14A(i), cmts. 1-5.
\textsuperscript{339} See infra app. § 14A(i)(1).
The same standard is set forth in section 6.02(b)(1) of the Corporate Governance Project. The duty of care responsibility of the change of control board, which is based on Section 4.01(a) of the Corporate Governance Project is set out in Proposed Section 14A(i)(3). Under this standard, each member of a change of control board has a duty to perform his or her duties (1) in good faith, (2) in a manner he or she reasonably believes is in the best interest of the corporation, and (3) with the care that a reasonably prudent person would exercise under similar circumstances. The director is required to make an inquiry when the circumstances would alert a reasonable director to the need for such an inquiry, and the extent of the inquiry is to be consistent with what "the director reasonably believes to be necessary." In discharging his or her functions, the director may rely on other persons in accordance with principles set forth in sections 4.02 and 4.03 of the Corporate Governance Project.

The business judgment rule, which is set forth in Proposed Section 14A(i)(4), codifies the business judgment rule set forth in section 4.01(c) of the Corporate Governance Project. Under this standard, a member of a change of control board ful-

340 See infra app. § 14A(i)(2).
341 See infra app. § 14A(i)(2) cmt. 1; CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.02(b)(1). This standard might be viewed as basically consistent with the team production model of corporate law developed in Margaret M. Blair & Lynn A. Stout, A Team Production Theory of Corporation Law, 85 U. VA. L. REV. 247 (1999). In describing this model, the authors say:

the primary job of the board of directors of a public corporation is not to act as agents who ruthlessly pursue shareholders' interests at the expense of employees, creditors, or other team members. Rather, the directors are trustees for the corporation itself—mediating hierarchies whose job is to balance team members' competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together.

Id. at 280-81; see also David Millon, New Game Plan or Business As Usual? A Critique of the Team Production Model of Corporate Law, 86 U. VA. L. REV. 1001 (2000).
342 See infra app. § 14A(i)(3) cmt. 1; CORPORATE GOVERNANCE PROJECT, supra note 2, § 4.01(a).
343 See infra app. § 14A(i)(3).
344 See infra app. § 14A(i)(3).
345 See infra app. § 14A(i)(3).
346 See infra app. § 14A(i)(4) cmt. 1; CORPORATE GOVERNANCE PROJECT, supra note 2, § 4.01(c).
fills his or her duty under Proposed Section 14A(i)(4) as long as the following four conditions are satisfied:

(1) the member must act in good faith.
(2) the member must not be interested in the subject of the business judgment. Since the Change of Control Official is required to make an *ex ante* judgment that the member is not interested, it would be a truly rare case in which a court could find that the director is interested. Further, even if a court were to find that one of the directors of a change of control board was interested, as long as the other two directors voted in favor of the transaction and were not materially influenced by the disqualified director, the action of the board would be protected by the business judgment rule.
(3) the member must be informed on the issue to the extent he or she reasonably believes to be appropriate under the circumstances. Since the Change of Control Official is required to make an *ex ante* determination that the member has sufficient experience in the merger and acquisition process, it would be a rare case in which this duty to make a proper inquiry would not be satisfied.
(4) the member must rationally believe that his or her business judgment is in the best interest of the corporation. The only conceivable situations in which this condition would not be satisfied would involve fraud, mental incapacity, or some other similar reason, and in any event, a board’s action would be protected by the business judgment rule as long as a majority of the directors approving the action is protected.\(^3\)\(^4\)

Proposed Section 14A(i)(5) mirrors section 4.01(d) of the Corporate Governance Project by placing the burden of proof on the person challenging the transaction to establish a breach of the duty of care and the inapplicability of the business judgment rule.\(^3\)\(^4\) The challenging party must also establish that the breach was the legal cause of the damages suffered.\(^3\)\(^4\) Unlike section 4.01(d) of the Corporate Governance Project, which has a normal standard of proof, Proposed Section 14A(i)(5) adopts a clear and convincing standard of proof for

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\(^3\)\(^4\) See *infra* app. § 14A(i)(4).

\(^3\)\(^4\) See *infra* app. § 14A(i)(5) cmt. 1; CORPORATE GOVERNANCE PROJECT, *supra* note 2, § 4.01(d).

\(^3\)\(^4\) See *infra* app. § 14A(i)(5).
establishing the business judgment rule is inapplicable. Adoption of this more difficult burden is appropriate given the small chance that a change of control board would lose the benefit of the business judgment rule. This approach should substantially reduce litigation in the merger and acquisition process.

The duty of care and the business judgment rule apply to all types of mergers and acquisition transactions: arm’s-length transactions, management buyouts, tender offers, and freezeouts. Because of the experienced and conflict-free change of control board, there is no need for: (1) the enhanced business judgment standard set out in section 6.02 of the Corporate Governance Project for defensive tactics in tender offers; (2) the special market test rules of section 5.15 for management buyouts; or (3) the special rules of sections 5.10 and 7.25 for freezeouts.

F. No Personal Liability, Insurance, and Indemnification

Proposed Section 14A(j)(1) provides that, except in the case of a showing by clear and convincing evidence of fraud, a member of a change of control board has no personal liability. This is consistent with director exculpation statutes such as section 102(b)(7) of the Delaware Business Corporation Law. Thus, any litigation involving the applicability of the business judgment rule will generally concern only the injunctive remedy.

Insurance and indemnification are provided for the members of a change of control board pursuant to Proposed Section 14A(j)(2). The SEC is to promulgate rules regarding insurance and indemnification, the cost of which will be borne by the target.

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350 See infra app. § 14A(i)(5) cmt. 1; CORPORATE GOVERNANCE PROJECT, supra note 2, § 4.01(d).
351 See infra app. § 14A(b).
352 See infra app. § 14A(j)(1).
354 See infra app. § 14A(j)(2).
355 See infra app. § 14A(j)(2).
G. Arbitration of Deadlocks in Majority Control Freezeouts

If a parent corporation proposes a freezeout transaction for a controlled subsidiary that is a public corporation, the subsidiary is an affected target. Consequently, a change of control board must be appointed for the subsidiary. Thus, in all such freezeout transactions, including short form mergers, a change of control board will first have to be appointed for the target-subsidiary, unless the shareholders have elected out.

If a controlling parent has sufficient voting control of a controlled subsidiary to be able to unilaterally effectuate a freezeout transaction, the change of control board for the subsidiary should not be able to block the transaction indefinitely. For example, the change of control board should not be able to completely ignore the short form merger provisions of a state's corporation law. On the other hand, the change of control board should protect the subsidiary's minority shareholders from being forced by the controlling parent to sell their shares for inadequate consideration.

Initially, the change of control board may block the controlling parent from unilaterally completing a freezeout transaction. However, to break a deadlock between the subsidiary's change of control board and the controlling parent, Proposed Section 14A(k) provides that if these two parties cannot reach a decision on the price and other terms of such a freezeout, then the price and other terms are to be determined in a binding arbitration proceeding. The SEC is to promulgate rules governing both the point at which an arbitration proceeding is to begin and the procedures for such proceedings.

H. Dissolution of the Change of Control Board

Under Proposed Section 14A(l), the change of control board is dissolved when the Change of Control Official grants a petition for dissolution. The petition is to be filed by the change of control board after the proposed merger or acquisition is either completed or abandoned. If the change of control

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355 See infra app. § 14A(k).
357 See infra app. § 14A(k).
358 See infra app. § 14A(l).
359 See infra app. § 14A(1).
board does not timely file the petition, either the SEC or a 5% shareholder or shareholders may file the petition. 360

I. Federal Jurisdiction and Preemption of State Law

Proposed Section 14A(m)(1) clarifies that any suits under the change of control provisions of Proposed Section 14A shall be brought in the appropriate federal district court, which generally will be the district court of the district in which the target has its headquarters. 361

Proposed Section 14A(m)(2) provides that the change of control provisions of Section 14A preempt all state statutes bearing on change of control transactions, such as control share statutes, business combination statutes, and disgorgement statutes. 362 In analyzing these laws, Professors Johnson and Millon have concluded, "[a]lthough often shrouded in the rhetoric of shareholder welfare, the primary goal of these laws is to protect various non-shareholder interests thought to be adversely affected by hostile takeover activity." 363

Even though these laws are preempted here, the target's change of control board can, pursuant to Proposed Section 14A(i)(2), give consideration to the interest of groups other than shareholders, provided such consideration does not significantly disfavor the long-term interests of the target's shareholders. 364

The preemption does not, however, extend to the normal provisions of corporate law governing shareholder voting on mergers and acquisitions. 365 The SEC is to promulgate regulations specifying those state statutes that are preempted. 366 Also, for the reasons outlined below, this provision preempts state appraisal statutes.

The preemption of state takeover statutes and of state appraisal statutes will greatly simplify the law governing mergers and acquisitions. Proposed Section 14A(m)(3) preempts all

360 See infra app. § 14A(1).
361 See infra app. § 14A(m)(1).
362 See infra app. § 14A(m)(2).
363 See infra app. § 14A(m)(2).
365 See infra app. § 14A(i)(2).
366 See infra app. § 14A(m)(3) cmt. 3.
367 See infra app. § 14A(m)(2).
corporate charter, by-law, or other contract provisions entered into by the target's regular board and bearing on mergers and acquisitions, including "golden parachute" arrangements, "poison pills," and lockups. This provision does not preempt normal charter and by-laws provisions governing shareholder voting on mergers and acquisitions. The SEC is to issue rules specifying those types of corporate provisions that are preempted.

J. Elimination of Appraisal Remedy

Adoption of the change of control concept would eliminate the need for appraisal proceedings in transactions in which a change of control board has acted. Since the change of control board would, through arm's-length negotiations, determine the price to be paid in a merger and acquisition, one may presume that the price would be fair, thereby eliminating the need for an appraisal proceeding to determine a fair price. Consequently, the appraisal remedy should be eliminated for all transactions in which a change of control board is appointed, thus substantially simplifying the law governing mergers and acquisitions.

Although this proposal may seem radical, it is consistent with the spirit of the Corporate Governance Project. In essence, the Corporate Governance Project provides that in each of the forms of acquisition in which appraisal rights are provided (i.e., arm's-length mergers and acquisitions under section 6.01, management buyouts under section 5.15, and freezeouts under sections 5.10 and 7.25), a price negotiated on an arm's-length basis by disinterested directors is presumed to be a fair price under Section 7.22.

Further, there is a fundamental flaw with the structure of the appraisal remedy. If under current law or the Corporate Governance Project, appraisal is the exclusive remedy and the court in an appraisal proceeding determines that the fair price is higher than the transaction price, then by definition the

See infra app. § 14A(m)(3).
See infra app. § 14A(m)(3) cmt. 1.
See infra app. § 14A(m)(3).
See infra app. § 14A(m)(2) cmt. 1.
See CORPORATE GOVERNANCE PROJECT, supra note 2, § 7.22 cmt. c.
acquisition price is less than fair. The only shareholders who receive the benefit of the fair price, however, are those shareholders who dissent and pursue their appraisal rights. The shareholders who do not dissent, generally most of the shareholders, are stuck with an unfair price.

Thus, there is a structural bias in the system for an acquiring corporation, particularly in management buyouts or freezeouts, to choose a less than fair price. As long as appraisal is the exclusive remedy, the only costs are: (1) the payment to the dissenters of the difference between the fair price and the transaction price, and (2) the litigation costs of the appraisal proceeding. The acquiring entity would have an economic incentive to pay less than fair value if the present value of the litigation costs is less than the difference between: (1) the aggregate fair price the non-dissenting shareholders would have received if they were all paid the fair price, and (2) the aggregate price they actually received. On the other hand, under the change of control concept, all of a target's shareholders will benefit from the "fair price" negotiated by the change of control board.

The structure of shareholder voting rights under both current law and the Corporate Governance Project may seem intuitively fair. Those shareholders that vote in favor of the merger get the benefit of the board's judgment. Those who dissent have the right to have their shares appraised. The appearance of fairness vanishes, however, when the practical aspects of shareholder voting are considered. Shareholders tend to vote with management even if the proposal is not in the best interest of the shareholders. Professors Bradley and Schipani theorize that the reason for this is that "decrease in value of the stock [from voting with management] is less than the costs investors would have had to incur to prevent it." They go on to conclude:

> Individuals will "produce" information up to the point where marginal costs equal marginal (expected) benefits. Under reasonable assumptions, individuals will "produce" a finite amount of information, which is to say they will decide to

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373 Id. at 71.
remain rationally ignorant about some things. If voting with management increases shareholder wealth, "on average," then investors will find it uneconomical to investigate and weigh the merits of each proxy proposal. They will simply follow management’s recommendation.\textsuperscript{374}

As additional support for this proposition, the authors point out that, under modern portfolio theory, shareholders should own a diversified portfolio, and consequently, such shareholders “care little about the fortunes of any one firm.”\textsuperscript{375}

In a merger or acquisition where appraisal is the exclusive remedy, the acquiring firm can exploit the rational ignorance of shareholders at a price by paying fair value to only those few shareholders who incur the costs to acquire the information that leads them to dissent. The adoption of the change of control concept would protect rationally ignorant shareholders from exploitation and thereby enhance shareholder welfare.

**K. Effective Date**

Proposed Section 14A(n) provides that Proposed Section 14A is to become effective three months after the date of enactment.\textsuperscript{376} This should allow time for (1) the SEC to appoint a Change of Control Official or Officials and to promulgate rules under Proposed Section 14A, and (2) the Change of Control Official or Officials to prepare to perform their functions.

Upon the effective date of Proposed Section 14A, all executory contracts of the corporation bearing on change of control transactions, such as "golden parachutes" and "poison pills," will become null and void.\textsuperscript{377} Consideration should be given, however, to grandfathering provisions with respect to which there has been significant detrimental reliance.\textsuperscript{378}

**L. Effect on the Williams Act**

The rules governing tender offers and open market purchases contained in the Williams Act, that is, sections 13(d),

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\textsuperscript{374} Id.
\textsuperscript{375} Id.
\textsuperscript{376} See infra app. § 14A(n)(1).
\textsuperscript{377} See infra app. § 14A(n)(2).
\textsuperscript{378} See infra app. § 14A(n)(2) cmt. 1.
(e), and (f), and 14(d) and (e) of the 1934 Act,\textsuperscript{379} will remain in place with the following modifications.

Rule 13e-3\textsuperscript{380} and Schedule 13E-3\textsuperscript{381} under the Securities Exchange Act of 1934 set forth rules governing going private transactions. These are transactions in which a controlling shareholder of a publicly-held corporation squeezes out the minority shareholders. Thus, the going private rules encompass all types of freezeout transactions. The rules are designed to promote fairness in such transactions by requiring, among other things, the controlling shareholder to explicitly state in its disclosure documents whether, in its view, the transaction is fair to the minority shareholders and to set forth in detail the basis for such a conclusion.\textsuperscript{382} These rules can be burdensome, and compliance can be time consuming.

If the change of control board concept is adopted, a change of control board would be appointed for every going private transaction, unless the corporation has elected out of the change of control provision. If the going private transaction was the second step in a two-step acquisition, the change of control board for the target would have already been appointed for the first step, and that board would remain in place for the second step. If the freezeout were divorced in time from the acquisition of the initial controlling interest, as in Weinberger, a change of control board would be appointed specifically for the freezeout.\textsuperscript{383}

A special rule would apply if the controlling shareholder has sufficient votes to effectuate the freezeout without the consent of the minority shareholders, and the change of control board and the controlling shareholder could not reach agreement on price within a reasonable period of time.\textsuperscript{384} In such case, the price and other significant terms would be determined by binding arbitration pursuant to rules promulgated by the SEC.\textsuperscript{385} Therefore, deadlocks would be prevented.

\textsuperscript{379} 15 U.S.C. §§ 78m(d)(e), 78n(d), (e) (1994).
\textsuperscript{380} 17 C.F.R. § 240 13e-3 (2000).
\textsuperscript{381} 17 C.F.R. § 240 13e-100 (2000).
\textsuperscript{382} 17 C.F.R. § 240.13e-3 (2000).
\textsuperscript{383} Weinberger v. UOP, Inc., 457 A.2d 701, 704-06 (Del. 1983).
\textsuperscript{384} See infra app. § 14A(k) cmt. 1.
\textsuperscript{385} See infra app. § 14A(k).
Under the change of control board concept, there is no need for rules such as Rule 13e-3 and Schedule 13E-3, because it can be presumed that the price negotiated by the change of control board or the price determined pursuant to arbitration would be fair to all of the minority shareholders. Consequently, it is proposed to exempt corporations that are subject to the change of control provision from the SEC’s going private rules.

Rule 14e-1 requires that a tender offer remain open for 20 business days. To give the change of control board sufficient time to analyze the situation, Rule 14e-1 should be amended to provide that a tender offer is to remain open for 25 business days after the Change of Control Official certifies that a change of control board has been appointed.

Rule 14e-2 requires the target’s board to take a public position on a tender offer within 10 business days of the commencement of the tender offer. As indicated above, this duty falls on the change of control board. To give the board adequate time to analyze the situation, Rule 14e-2 should be amended to extend the deadline to 15 business days after the Change of Control Official certifies that a change of control board has been appointed.

M. Inapplicability of Golden Parachute and Greenmail Provisions of the Internal Revenue Code

The Internal Revenue Code limits the deduction of certain golden parachute payments made by a target corporation to its management. Also, the Code imposes an excise tax on certain greenmail payments made by a target on the repurchase of target stock held by an unwanted shareholder. The purpose of these provisions is to curtail actions of a target’s board that would likely result in members feathering their own nests or entrenching themselves.

Since the change of control board would be in control of the decision to make “golden parachute” and “greenmail payments,” any such payments made by a target would not be for such

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entrenchment purposes. Consequently, the “golden parachute” and “greenmail” provisions of the Code should not apply to corporations subject to the change of control provision.

N. Election-Out

Pursuant to Proposed Section 14A(o), the public shareholders of a corporation may elect not to have the change of control provisions or selected subsections of these provisions apply to the corporation. Thus, for example, the public shareholders of a corporation might elect to have the change of control provision apply in only the situation in which the corporation becomes a target of a hostile tender offer. I believe that few corporations will elect out, and therefore, the “election-out” rather than an “election-in” should be consistent with the “conventional approach to statutory defaults [which] is to choose what a majority of firms would adopt.”

The procedures governing the operation of this election-out provision are to be specified by the SEC. Such procedures are to be designed to ensure that the proposal for an election-out comes from public shareholders who have not been influenced by management or by a controlling shareholder and that the management and controlling shareholders in no way influence the vote on such a proposal.

Thus, if independent public shareholders decide on their own initiative that it is in the best interest for the corporation to be free of this provision, they can vote to elect-out. In such a case, the current state and federal rules regarding mergers, acquisitions, and tender offers would apply to the elected-out corporation. The change of control concept is, therefore, a default provision. For the reasons discussed below, the only way to effectuate the change of control concept is to have federal preemption, with the possibility of an election out.

This election-out provision is very broad. Thus, even after a change of control board is appointed, a target’s shareholders may, pursuant to regulations promulgated by the SEC, elect to remove the change of control board and thereby make the tar-

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390 See infra app. § 14A(o).
392 See infra app. § 14A(o).
393 See infra app. § 14A(o) cmt. 1.
get subject to normal state and federal rules. As a consequence, if an acquiror has, for example, made an offer for the target at a substantial premium and the change of control board is "just saying no," the target's shareholders could elect to replace the change of control board with a normal board.

The presence of the election-out rule should prevent a domestic corporation from reincorporating as a foreign corporation to avoid Proposed Section 14A.

One commenter suggested that this change of control provision might be made mandatory with a sunset provision, such as automatic repeal after ten years, unless the provision is extended by Congress. It is suggested that this would permit a more accurate comparison of the empirical results of the change of control concept with such results under current law. I believe that it is preferable to allow shareholders to elect out of the provision if they choose; however, I would not object to having this concept subject to a sunset, unless extended.

O. Regulatory Exemption

Proposed Section 14A(p) gives the SEC the authority to exempt certain publicly-held corporations from this provision. The exemption may apply if, for example, a single individual or family owns a controlling block of shares or if the corporation has recently become public and the managers or organizers own a significant stock interest. This exemption should minimize the possibility that closely-held corporations will refuse to become public to avoid the application of Proposed Section 14A.

P. Non-Bona Fide Offers

Proposed Section 14A(q) makes it illegal for a person to make a non-bona fide tender offer or a non-bona fide proposal to a target for the purpose of causing a trigger event to occur, thereby triggering the appointment of a change of control board. A non-bona fide offer or proposal is one in which the purported acquiror has no intent of completing the transaction.

394 See infra app. § 14A(p).
395 See infra app. § 14A(p) cmt. 1.
396 See infra app. § 14A(p) cmt. 1.
397 See infra app. § 14A(q).
This provision should deter parties from employing Proposed Section 14A for strategic purposes.\textsuperscript{398}

Q. \textit{Number of Change of Control Boards That Would Have Been Appointed in 1995 and 1996 and Projection of Future Number of Change of Control Boards}

An analysis of the SEC’s report on its full disclosure reviews contained in its 1996 Annual Report\textsuperscript{399} provides a basis for estimating the approximate number of change of control boards that would likely be appointed each year. As indicated below, in view of the increase in the number of change of control transactions in recent years, the estimate based on the 1996 Report is adjusted upward.

In 1995, 140 tender offer statements were filed on Schedule 14D-1, 225 proxy statements were filed for mergers and “going private” transactions, 77 “going private” schedules were filed, and 59 contested proxy solicitations occurred. Likewise, in 1996, 165 tender offer statements were filed, 261 proxy statements for mergers and “going private” transactions were filed, 100 “going private” schedules were filed, and 62 proxy solicitations occurred. In each of these transactions, a change of control board would be appointed. In both 1995 and 1996, these schedules apparently did not involve a proxy statement but rather involved freezeout mergers in which the target’s shareholders did not have the right to vote, but did receive a disclosure statement (i.e. an information statement) under section 14(c) of the 1934 Act.\textsuperscript{400}

Change of control boards would also be appointed upon the filing of a Schedule 13D (which is required for acquisitions of more than 5% of the stock of a public issuer),\textsuperscript{401} provided that the purpose of the acquisition is to effectuate a change of control of the issuer.\textsuperscript{402} The SEC's Annual Report does not list the number of such filings, but it can be assumed that many are ultimately followed by the filing of a tender offer statement or a merger proxy statement, and thus would be automatically

\textsuperscript{398} See infra app. § 14A(q)(1).
\textsuperscript{399} 1996 S.E.C. ANN. REP. 79.
\textsuperscript{400} Id.
\textsuperscript{401} 17 C.F.R. § 240.13d-101 (2000).
\textsuperscript{402} See infra app. § 14A(b)(4).
counted with these documents. There certainly would be other transactions in which a Schedule 13D is filed, indicating a change of control purpose, but the Schedule 13D is not followed by the filing of either a tender offer statement or a merger proxy statement. It is difficult to estimate the number of such cases, but it would seem that an estimate of no more than 50 each year would be reasonable.

Thus, the estimated number of change of control boards that would likely have been required if this concept had applied in 1995 and 1996 would be as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Tender Offers</th>
<th>Mergers and Going Private Proxy Statements</th>
<th>Going Private Schedules</th>
<th>Contested Proxy Solicitation</th>
<th>Schedule 13Ds for Change of Control Purpose, without a subsequent tender offer or merger (Estimated)</th>
<th>Estimated Number of Change of Control Boards</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>140</td>
<td>225</td>
<td>77</td>
<td>59</td>
<td>50</td>
<td>551</td>
</tr>
<tr>
<td>1996</td>
<td>165</td>
<td>261</td>
<td>100</td>
<td>62</td>
<td>50</td>
<td>638</td>
</tr>
</tbody>
</table>

There has been an increase in the number of change of control transactions taking place since 1996, and it would not be unrealistic to assume that in some years 1000 change of control boards might be appointed. This assumes that none or very few corporations elected out of the provision.

Although this may seem like a large number of change of control boards, the above statistics demonstrate that there are a large number of change of control transactions taking place in our economy each year where the potential conflict between the directors and the shareholders may be preventing the maximization of shareholder value. The adoption of the change of control concept would eliminate these conflicts, maximize shareholder value, and significantly reduce the substantial litigation that arises in these transactions. Further, the SEC could appoint Change of Control Officials for various geograph-
ic areas, because the change of control boards would be spread throughout the country.

IV. ILLUSTRATION OF APPLICATION OF THE CHANGE OF CONTROL BOARD PROPOSAL IN SEVERAL SEMINAL TAKEOVER CASES

A. Introduction

This section discusses how the change of control board concept would likely have applied in the several seminal cases discussed above. In connection with arm's-length transactions, this section examines the potential impact of the change of control provision on the facts presented in (1) Smith v. Van Gorkom, 403 (2) Paramount Communications, Inc. v. Time Inc. (Time-Warner), 404 and (3) Paramount Communications, Inc. v. QVC Network, Inc. 405

For management buyouts, this section analyzes the impact of the change of control provision on the facts in Hanson Trust PLC v. ML SCM Acquisition, Inc. 406 and Kahn v. Dairy Mart Convenience Stores, Inc. 407

In considering tender offers, this section examines the impact of this provision on the facts in (1) Revlon, Inc. v. MacAndrews & Forbes Holdings, 408 (2) Time-Warner, 409 (3) QVC, 410 (4) Moore Corp. Inc. v. Wallace Computer Services, Inc., 411 and (5) Norfolk Southern Corp. v. Conrail, Inc. 412

For freezeouts, this section examines the impact of the change of control provision on the facts in Weinberger v. UOP, Inc. 413 and Kahn v. Lynch Communication Systems, Inc. 414

403 488 A.2d 858 (Del. 1985).
404 571 A.2d 1140 (Del. 1989).
405 637 A.2d 34 (Del. 1994).
406 781 F.2d 264 (2d Cir. 1986).
408 506 A.2d 173 (Del. 1986).
409 571 A.2d 1140 (Del. 1989).
410 637 A.2d 34 (Del. 1994).
413 457 A.2d 701 (Del. 1983).
414 638 A.2d 1110 (Del. 1994).
B. Application of Change of Control Concept

Assuming the shareholders have not elected out under Section 14A(o), each of the target corporations in these ten cases (i.e., Trans Union in Van Gorkom, SCM in Hanson Trust, Dairy Mart in Dairy Mart Convenience Stores, Revlon in Revlon, Time in Time-Warner, Paramount in QVC, Wallace in Moore, Conrail in Norfolk Southern, UOP in Weinberger, and Lynch in Lynch Communications) is a public corporation with respect to which a trigger event has occurred. Therefore, each of these targets is an “affected issuer” under Proposed Section 14A(a).

Consequently, under Proposed Section 14A(c)(1), the board of each of these targets is required to petition the Change of Control Official for the appointment of a change of control board. Under Proposed Section 14A(e), the Change of Control Official must promptly appoint a change of control board, which normally will consist of three members, each of whom will have to be both qualified to serve on such a board and completely disinterested in the transaction. Normally, one of the members will be appointed from the regular board, provided such person is otherwise qualified to serve.

Pursuant to Proposed Section 14A(f)(1), each of the change of control boards has complete authority over all matters relating to the proposed transaction. Pursuant to Proposed Section 14(A)(f)(2), each change of control board would likely hire its own completely independent and conflict-free attorney and investment banker. Pursuant to Proposed Section 14A(f)(4), each of the change of control boards would likely have extensive consultations with the regular boards concerning their views on the proposed transaction.

Each of the change of control boards would be subject to the duty of care in Proposed Section 14A(i)(3) and the business judgment rule in Proposed Section 14A(i)(4). This is the case without respect to the form of the transaction, that is,

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415 See infra app. § 14A(a)-(b).
416 See infra app. § 14A(c)(1).
417 See infra app. § 14A(e).
418 See infra app. § 14A(f)(1).
419 See infra app. § 14A(f)(2).
420 See infra app. § 14A(f)(4).
421 See infra app. § 14A(i)(3)-(4).
negotiated merger, management buyout, tender offer, or freezeout merger. In each of the situations it can be expected that the change of control board would clearly satisfy its duty of care obligation and would clearly receive the benefit of the business judgment rule. Pursuant to Proposed Section 14A(j)(1), absent fraud, no member of the change of control board would face liability.\textsuperscript{422}

Pursuant to Proposed Section 14A(m), any suits dealing with the change of control board must be brought in the appropriate federal district court.\textsuperscript{423} Also, under this section, the change of control provisions preempt state law statutes bearing on change of control transactions,\textsuperscript{424} such as Pennsylvania's takeover law, which is very protective of a target's management and was at issue in \textit{Norfolk Southern},\textsuperscript{425} and Delaware's business combination statute, which in certain circumstances prevents a hostile acquiror from effectuating a second step freezeout transactions.\textsuperscript{426} However, because of the protection afforded by the business judgment rule, it is highly unlikely that there would be litigation involving the change of control boards in any of these cases.

Turning to the facts of the cases illustrating arm's-length transactions, the change of control board for Trans Union would have decided what steps should be taken in attempting to sell Trans Union, and there certainly would not have been a quick deal with Jay Pritzker. Also, the change of control boards for Time and Paramount would likely have not entered into the original merger agreements with Warner and Viacom, without first undertaking a careful market test. The impact of the change of control provisions on Time and Paramount in connection with the tender offer aspect of these cases is examined further below.

Turning to management buyouts, the change of control board for SCM clearly would not have granted Merrill Lynch and the management group the option on SCM's crown jewels without getting an opinion from the investment banker on the

\textsuperscript{422} See infra app. § 14A(j)(1).
\textsuperscript{423} See infra app. § 14A(m)(1).
\textsuperscript{424} See infra app. § 14A(m)(2).
value of the optioned assets. Also, the change of control board for Dairy Mart would not have been under the control of the controlling shareholder, and, therefore, would have actively sought alternative offers.

In connection with the tender offer transactions, the change of control board for Revlon would not have extended the auction-ending lockup to Forstmann, but would have ensured that Revlon went to the highest bidder.

Even if the change of control board for Time had entered into a merger agreement with Warner, the board likely would have given the Time shareholders the opportunity to choose whether to tender to Paramount, particularly after Paramount raised its price to $200 per share. Time's board was likely misled by an overly optimistic valuation of Time provided by the board's investment banker, Wasserstein Perella. Wasserstein may have had a strong incentive to see the Time-Warner transaction proceed. This would not have been the case with an investment banker for Time's change of control board.

Thus, the result with a change of control board in Time-Warner likely would have been significantly different from the result flowing from the court's decision. After taking account of a stock split that Time-Warner effectuated, Paramount's $200 offer in 1989 translates into an offer of $50 per share in 1999. The price of Time-Warner's shares did not reach the level of Paramount's 1989 offer until 1997. Wasserstein's prediction was that these shares, taking account of the split, would be trading in 1993 in a range of $92 to $100.50. There can be no doubt that Time's shareholders would have been much better off if they could have accepted the Paramount offer.

The change of control board for Paramount in QVC likely would not have entered into the merger agreement with Viacom without exploring thoroughly and openly a transaction with QVC, which was very interested in making a competing bid. The likely effect of such an exploration would have been an auction of Paramount to the highest bidder, which was the effect of the court's decision.

The only reason that Paramount was ultimately sold to Viacom pursuant to the auction for $110 per share, when the

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427 See Reed Abelson, When Boards Say 'No Deal' to Holders, N.Y. TIMES, Oct. 6, 1996, at C1.
original merger price was only $70 per share, was the presence of QVC, which was willing to become a hostile bidder. If QVC had not been willing to make a bid, it is likely that there would not have been an auction, and Paramount’s shareholders would have received the $70 per share set out in the original merger agreement. Under the circumstances in QVC, even if QVC had not been interested, it is highly unlikely that Paramount’s change of control board would have entered the merger agreement with Viacom without first canvassing the market for other potential purchasers. Thus, even if QVC were not already interested in making an offer for Paramount, the change of control board might have induced QVC to make such an offer.

The change of control board for Wallace may or may not have made a decision to keep the pill in place and reject Moore’s offer. The decision would have depended upon the assessment by the change of control board of the expected value of Wallace after consulting with the independent investment bankers for the change of control board. It is likely that the investment bankers for the change of control board would be more direct than Goldman Sachs seems to have been in dealing with Wallace’s board.

In the Conrail transaction, Proposed Section 14A(m)(2) would have preempted Pennsylvania’s takeover laws, and, therefore, the Conrail change of control board would have been subject to the standard duty of care and the business judgment rule.428 It is highly unlikely that Conrail’s change of control board would have rejected the Norfolk offer in favor of CSX’s lower offer. The end result of a division of Conrail between CSX and Norfolk Southern may have also occurred with a change of control board, but this result could have been reached without lengthy and costly litigation.

Turning to freezeouts, the change of control board for UOP would have had meaningful negotiations with Signal concerning an appropriate price to be paid in the freezeout merger. If the parties could not have reached an agreement, then under Proposed Section 14A(k), the price and other terms of the transaction would have been determined by arbitration.429 A

428 See infra app. §§ 14A(m)(2), (i)(3)-(4).
429 See infra app. § 14A(k).
similar result would have been reached under the facts in Lynch Communications.

The change of control board in each of these cases would have addressed the inherent conflicts of interest faced by the targets' directors.

In summary, the actions taken by a change of control board would likely have produced the same results as those reached by the courts in Van Gorkom, Hanson Trust, Dairy Mart, Revlon, QVC, Weinberger, and Lynch. On the other hand, in Time-Warner, Moore, and Norfolk Southern, a change of control board likely would have reached a different result than that reached by the courts. In all these cases, the change of control boards would have been much more protective of the interest of the targets' shareholders than were the targets' boards, and in each case it is unlikely that there would have been litigation concerning actions taken by the change of control board.

V. WHY NOT USE DISINTERESTED DIRECTORS UNDER EXISTING LAW?

An obvious question is presented by the proposal for a change of control board: Why not simply rely on disinterested directors under current law to perform the functions of the change of control board? The Corporate Governance Project adopts the disinterested director concept in dealing with management buyouts under section 5.15, non-majority control freezeouts under section 5.10, and majority control freezeouts under section 7.25. Also, the Corporate Governance Project indicates that in the context of defensive tactics governed by section 6.02, interested directors who participate in a decision should not be held financially liable if the “number of disinterested directors who approve [the defensive action] is legally sufficient to authorize action of the corporation . . . .”

430 CORPORATE GOVERNANCE PROJECT, supra note 2, § 5.15.
431 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 5.10.
432 See CORPORATE GOVERNANCE PROJECT, supra note 2, § 7.25.
433 CORPORATE GOVERNANCE PROJECT, supra note 2, § 6.02 cmt. a (emphasis added).
In addition, section 3A.01 of the Corporate Governance Project recommends that every large publicly-held corporation have a majority of independent directors.\textsuperscript{434} Similarly, the Committee on Corporate Laws of the American Bar Association suggests in its Corporate Director's Guidebook that "at least a majority of members of the boards of publicly-held corporations should be independent of management."\textsuperscript{435} Further, the Business Roundtable, in its Statement on Corporate Governance, suggests that a "substantial majority of the directors of [a large publicly owned] corporation should be outside (non-management) directors."\textsuperscript{436} Also, Martin Lipton and Jay Lorsch have suggested that public corporations should have a "ratio of at least two independent directors to any director who has a connection with the company, either as management or substantial customer or supplier of goods or services."\textsuperscript{437}

There is also empirical evidence that the presence of independent directors on a board can benefit the shareholders of a target company. One study has found that the shareholders of a corporation that issues a poison pill are likely to experience positive abnormal stock returns upon the announcement of the adoption of the pill if the board of the corporation consists of a majority of outside directors.\textsuperscript{438} On the other hand, the abnormal returns were negative if less than a majority of the board consisted of outside directors. Abnormal returns are those falling either above (i.e. positive) or below (i.e., negative) what would be predicted by normal market moves. The computation of abnormal returns, which is performed through what is referred to as an event study, is a statistical measure of the effect a particular event has on a corporation's share price.

\textsuperscript{434} See Corporate Governance Project, supra note 2, § 3A.01.
\textsuperscript{435} Committee on Corporate Laws, American Bar Ass'n, Corporate Director's Guidebook 16 (2d ed. 1994) [hereinafter Corporate Director's Guidebook].
\textsuperscript{436} The Business Roundtable, Statement on Corporate Governance, 10 (Sept. 1997).
\textsuperscript{438} James A. Brickley et al., Outside Directors and the Adoption of Poison Pills, 35 J. Fin. Econ. 371, 387-89 (1994) (discussing this article and similar articles); see also Laura Lin, The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence, 90 Nw. U. L. Rev. 898, 930-937 (1996).
Furthermore, it has been found that in management buyouts of publicly-held firms the cumulative abnormal returns of the target's shareholders are substantially higher when the target's board consists of a majority of independent directors. There is also evidence that the wealth effects on the shareholders of acquiring firms are likely to be more favorable when independent directors comprise at least half of the acquiror's board.

In a recent study of the impact of disinterested directors on corporate performance, Professors Bhagat and Black conclude that "[t]aken as a whole, the studies of the role of the target company's board in an acquisition provide evidence that majority-independent boards extract higher prices from bidders." However, with regard to takeover defenses, they conclude that "there is little evidence that relatively independent boards behave in a significantly more (or less) shareholder-friendlier fashion than other boards when they adopt and employ takeover defenses."

In addressing the relationship between board composition and general firm performance, Professors Bhagat and Black have found that "there is no convincing evidence that increasing board independence, relative to the norms that currently prevail among large American firms, will improve firm performance." Similarly, Professor Lin has found that the empirical evidence is "mixed regarding whether the proportion of outside directors has a positive effect on overall firm performance." However, Ira Millstein, a leading corporate practi-
tioner, and Professor Paul W. MacAvoy in a 1998 study found "a statistically significant relationship between an active, independent board and superior corporate performance as measured by earnings in excess of costs of capital over the industry average." They go on to conclude that "[C]orporations that received an 'A+' CalPERS corporate governance grade and corporations that graded as having active governance 'present' both performed significantly better in generating earnings in the 1990s than did the other corporations in the sample of large domestic corporations.”

Notwithstanding these divergent findings on general performance, there seems to be strong empirical evidence to the effect that independent directors benefit shareholders in various acquisition contexts. Thus, it seems clear that action by disinterested directors in the merger and acquisition context is preferable to action taken by interested directors. However, in the words of former Chancellor Allen of the Delaware Court of Chancery, "the jury is still out on the question whether the special committee device [that is, disinterested directors] works well enough, often enough, for the law to continue to accord it weight." The proposal here for a change of control board is designed to ensure that the directors acting for the target in a change of control situation are truly disinterested and knowledgeable.

Chancellor Allen's skeptical view of the true independence of disinterested directors also has been expressed by two prominent judges on the Seventh Circuit: Judge Richard Posner, a vigorous supporter of an economic approach to the law, and Judge Cudahy, who apparently is not a disciple of the law and economics movement.

The authors say that the findings of the Bhagat and Black study suggest that "American corporations need to do more than just place independent directors on their boards to increase shareholder wealth via their corporate governance activities." Id. at 161.


447 William T. Allen, Independent Directors In MBO Transactions: Are They Fact or Fantasy?, 45 BUS. LAW. 2055, 2062-63 (1990). For a discussion of some of the practical aspects of using independent directors for special transactions, see A. Gilchrist Sparks, III & Mark Hurd, Special Negotiating Committees, 30 REV. SEC. & COMMODITIES REG. 97 (Apr. 23, 1997).
In his dissenting opinion in Panter v. Marshall Field & Co., Judge Cudahy criticizes the majority for applying Delaware’s normal business judgment rule in examining a board’s defensive tactics. He points out that the “theoretical justification for the ‘hands off’ precept of the business judgment rule is that courts should be reluctant to review the acts of directors in situations where the expertise of the directors is likely to be greater than that of the courts.” He adds, however, that if the directors are afflicted with a conflict of interest, relative expertise is no longer crucial, and, in such cases, “courts have no rational choice but to subject challenged conduct of directors . . . to their own disinterested scrutiny.”

Judge Cudahy then says that the Panter majority relies heavily on the business judgment rule in presuming good faith on the part of the directors and “attaches special significance to the ‘independence’ of Field’s [i.e., the target’s] Board.” He then challenges the assumption that Field’s Board is independent:

The fact that Field’s may have had a majority of non-management (independent) directors is hardly dispositive. The interaction between management and board may be very strong even where, as here, a relationship of symbiosis seems to prevail over the normal condition of “management domination.” Whether the relationship is symbiotic or management “dominates,” I do not think it necessary to rely primarily on . . . [direct] pecuniary relationships . . . to establish a conflict of interests here. . . . [T]he very idea that, if we cannot trace with precision a mighty flow of dollars into the pockets of each of the outside directors, these directors are necessarily disinterested arbiters of the stockholders' destiny, is appallingly naive.

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448 646 F.2d 271, 299 (7th Cir. 1981) (Cudahy, J., concurring and dissenting).
449 493 A.2d 946 (Del. 1985).
450 Panter, 646 F.2d at 299-312 (Cudahy, J., concurring and dissenting).
451 Id. at 300 (Cudahy, J., concurring and dissenting).
452 Id. (Cudahy, J., concurring and dissenting).
453 Id.
454 Id.
Judge Cudahy then goes on to catalogue how independent directors are in his view interested:

Directors of a New York Stock Exchange-listed company are, at the very least, "interested" in their own positions of power, prestige and prominence (and in their not inconsequential perquisites). They are "interested" in defending against outside attack the management which they have, in fact, installed or maintained in power, "their" management (to which, in many cases, they owe their directorships). And they are "interested" in maintaining the public reputation of their own leadership and stewardship against the claims of "raiders". . . . 455

The types of "interests" identified by Judge Cudahy are not cognizable interests under current law or under the Corporate Governance Project. Section 1.23 of the Corporate Governance Project provides that a director is interested in the transaction if the director: (1) is a party to the transaction; (2) has a business, financial or [family] relationship with a party and the relationship could reasonably be expected to adversely affect the director's judgment; (3) has a direct or indirect material pecuniary interest in the transaction (other than normal director's fees and benefits) and the interest could reasonably be expected to adversely affect the director's judgment; or (4) is under the control of a party to the transaction or one who has a material pecuniary interest in the transaction and such control could reasonably be expected to adversely affect the director's judgment. 456

Judge Posner's assessment of the independence of outside directors seems to be in complete agreement with that of Judge Cudahy. In Dynamics Corp. v. CTS Corp., 457 Judge Posner, in finding that the target's board had violated its fiduciary duty in issuing a poison pill, stated:

When managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the takeover attempt succeeds, they have a clear conflict of

455 Id. at 300-01.
456 CORPORATE GOVERNANCE PROJECT, supra note 2, § 1.23.
interest, and it is not cured by vesting the power of decision in a board of directors in which insiders are a minority. No one likes to be fired, whether he is just a director or also an officer. The so-called outsiders moreover are often friends of the insiders. And since they spend only part of their time on the affairs of the corporation, their knowledge of those affairs is much less than that of insiders, to whom they are likely therefore to defer.  

These observations by Judges Cudahy and Posner in the context of an examination of a board’s defensive action are consistent with Chancellor Allen’s examination of the role of independent directors in management buyouts. The Chancellor points out that there are some cases, like *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, that support the cynical view that independent boards do not properly function; and there are other cases, such as *In re RJR Nabisco Shareholders Litigation*, in which the independent directors appeared to be “energetically exercising informed and independent judgment in the sale of the enterprise.” The Chancellor goes on to summarize the Delaware cases as follows: “[I]n the sale context, the Delaware cases suggested that it is possible for ‘outside’ directors to function independently. But those cases demonstrate as well that not every decision by an apparently disinterested special committee deserves or will be accorded that respect.” Notwithstanding the bright spots, he “confess[es] a painful awareness of the ways in which the device may be subverted and rendered less than useful.”

The Chancellor also observes that outside directors who serve on a special committee to preside over the sale of a company have a “fairly unappetizing assignment” because “no matter what the director does he will probably be sued for it.” He further points out that outside directors have a tendency to

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458 *Dynamics*, 794 F.2d at 256.
459 781 F.2d 264 (2d Cir. 1986).
462 *Id.*
463 *Id.* at 2056.
464 *Id* at 2061.
rely on their advisers because "[f]requently, the outside directors who find themselves in control of a corporate sale process have little or no experience in the sale of a public company. They are in terra cognito." Thus, there is not only the problem with the potential conflict of interest, but also with inexperienced outside directors. This problem can lead to passivity of the type manifested by the independent board members in Smith v. Van Gorkom, which involved an arm's-length transaction, and in Weinberger v. UOP, Inc., which involved a freezeout.

Thus, there are cases dealing with each of the types of mergers and acquisitions addressed here (that is, arm's-length mergers and acquisitions, management buyouts, tender offers, and freezeouts) in which independent board members have failed to act in the best interest of the shareholders. Further, even if their actions appear on their face to be proper, there is always the reality that independent directors will conduct themselves with a view toward litigation and in ways which may "obscure their true motives."

The change of control board concept addresses directly both the conflict problem and the inexperience problem identified by Chancellor Allen and also the passivity problems illustrated in Van Gorkom and Weinberger. The Change of Control Official must make an ex ante judgment that each appointee to a change of control board has both (1) no conflict of interest of the type outlined above by Judge Cudahy or set forth in section 1.23 of the Corporate Governance Project, and (2) the requisite experience to address the issues presented by the proposed change of control transaction. It can, therefore, be expected that change of control boards would aggressively pursue the best interest of the corporation and the shareholders without respect to the type of transaction or the identity of the parties.

Most of the boards of the target companies in the seminal cases examined above had a majority of disinterested directors, and in each of those cases the boards appear not to have acted in the best interest of the target's shareholders. While this does

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465 Id.
466 488 A.2d 858 (Del. 1985).
467 457 A.2d 701 (Del. 1983).
not show that disinterested directors never work properly in the merger and acquisition context, it does show that there are many situations in which the performance of disinterested directors is not optimal.

Finally, while it can be expected that a change of control board would act in the interest of the target's shareholders and thereby ensure that they are treated fairly, Professors Bhagat and Black, among others, have argued that the "[higher pre-mia [resulting from the use of disinterested directors] are not unequivocally good . . . ."

They elaborate as follows:

If both bidder and target are publicly traded, a higher takeover price is simply a wealth transfer from the bidder's shareholders to the target's shareholders. Moreover, if shareholders are diversified, then over a number of transactions, the bidder's shareholders and the target's shareholders are the same people. The key to economic efficiency in the takeover market is not the price paid by the acquirer, but instead: (i) whether there is a good strategic fit between the acquirer and the target (for which a good measure is combined bidder and target returns, not target returns alone); and (ii) whether there is an optimal frequency of takeovers, taking into account both their efficiency benefits and transaction costs.

This line of reasoning suggests that a diversified investor should prefer takeover governance rules that promote the "optimal frequency of takeovers." But, it is impossible to know the "optimal frequency of takeovers." Further, not all investors are diversified, and it can be expected that virtually all investors in a target will want very much to be paid a fair price for their shares. Moreover, if for whatever reason, investors feel that the change of control concept is not in their interest, they can elect out of the provision.

One final point on the "optimal frequency of takeovers" is that the current rules in Delaware and in many other states give a target's directors wide latitude in defending against unwanted takeovers. These rules may, therefore, have the effect of deterring takeovers because acquirors may not want to incur the expense and time needed to overcome a recalcitrant

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469 Bhagat & Black, supra note 441, at 926.
470 Id.
management. This should not be the case with a change of control board because such a board will not erect artificial barriers to the completion of an acquisition, and even if a change of control board were to erect artificial barriers, the target's shareholders could, pursuant to SEC rules, vote to eliminate the change of control board. Thus, as compared with present law, the adoption of the change of control concept may move the merger and acquisition market place in the direction of the "optimal frequency of takeovers."

Finally, one commenter suggested that if the change of control board concept were more efficient than current law, it could be expected that companies issuing shares in initial public offerings would include similar provisions requiring action by disinterested directors in their charters, assuming it would be legal for them to do so. It appears, however, that IPO companies are moving in the opposite direction by including measures in their charters that can help deter takeovers, such as staggered boards.471

VI. WHY A FEDERALLY MANDATED CHANGE OF CONTROL BOARD

A. Introduction

There is nothing to prevent a state legislature from enacting a provision that mandates a change of control board. However, the "[t]wo interest groups [that] have dominated the development of American corporate law—[the] corporate lawyers and corporate managers...."472 would likely be able to block the enactment of any such legislation. And, in any event, state legislative action in adopting such a requirement could be avoided by merely reincorporating the corporation in a state that did not have such a provision. Also, it is unrealistic to think that many corporations would voluntarily include such a

471 Coates, Takeover Defenses, supra note 298, at 277.
provision in their articles (assuming it would be permissible to do so), because the current board has control over the proxy process and shareholder proposals do not tend to succeed. As explained by Professors Bradley and Schipani, shareholders tend to vote with management because they "find it uneconomical to investigate and weigh the merits of each proxy proposal."\(^{473}\)

Thus, the only practical avenue for making the change of control board effective for publicly-held corporations is to have a federally mandated provision that applies uniformly to all registered corporations. Further, this approach is basically consistent with the approach Congress took with the enactment of the Securities Litigation Uniform Standards Act of 1998, which makes federal court the exclusive venue for most securities fraud class action [litigation] involving nationally traded securities.\(^{474}\) In fact, the change of control concept is arguably not as dramatic a change as that enacted by the Securities Litigation Uniform Standards Act of 1998 because corporations can opt-out of the change of control provision.

It can be anticipated that many will object to the need for this type of federal rule. For example, Professor Fischel has argued that there is no "convincing theoretical case" and no empirical evidence supporting the view that a majority of independent directors will increase shareholder welfare.\(^{475}\) Although the empirical evidence on the issue of whether independent directors have an effect on overall firm performance is "mixed,"\(^{476}\) there is evidence that the presence of independent directors in various merger and acquisition contexts can have a positive effect on shareholder welfare.\(^{477}\) This proposal goes one step further by insuring that in a change of control trans-

\(^{473}\) Bradley & Schipani, supra note 372, at 71.


\(^{476}\) Lin, supra note 438, at 962.

\(^{477}\) Id. at 930-37.
action, the target has a change of control board that is unquestionably independent and also knowledgeable in addressing change of control issues.

In arguing against the change of control board, some might endorse the argument of Professor Fischel that it is preferable to "allow private parties to organize in whatever manner they wish,"478 because if the change of control board concept "really will increase shareholders' welfare, it will be undertaken voluntarily...."479 But for reasons noted above, it is highly unlikely that a state would enact a change of control provision because companies would likely reincorporate to avoid the provision. Thus, as a practical matter the federal route is the only viable option. Furthermore, since there is an elect-out provision, the change of control concept is merely a default rule, and if it is inefficient companies could be expected to elect-out. My guess, however, is that there would be few elections out. If I am completely wrong and all corporations elect out, then there is merely a return to the status quo, and it would thereby be demonstrated, by a fairly costless election out procedure, that the status quo maximizes shareholder welfare. On the other hand, if I am right, the enactment of this provision could substantially enhance shareholder welfare.

Professor Fischel has criticized Professor Cary's proposal for federally mandated minimum corporate standards as being "contradicted by all available theoretical and empirical evidence,"480 and it can be expected that this proposal will be criticized on similar grounds. Also, criticism along similar lines can be expected from the Delaware corporate bar. For these reasons, this section examines the empirical case for a federally mandated change of control board.

B. Comparison of This Proposal With Federalization Proposals of Professor Cary and Others

Professor Cary has argued that Delaware's legislature and courts in an effort to attract corporations to that state have

478 Fischel, supra note 475, at 1284.
479 Id.
engaged in a "race to the bottom" by not providing adequate protection of shareholders' rights. He, therefore, argues that federal standards of corporate responsibility should be enacted. Specifically, he has proposed "minimum corporation law provisions which shall be applicable to companies doing business in interstate commerce and construed by federal judicial standards." His proposal is for a Federal Corporate Uniformity Act that would apply to all corporations having more than $1 million in assets and 300 shareholders. Although these companies would still incorporate in the jurisdictions of their choice, they would be subject to federal rules governing such items as: (1) fiduciary standards, (2) interested directors, (3) issuance of nonvoting shares, and (4) indemnification of directors.

Others have made similar proposals, including Professor Schwartz, who argues that Professor Cary's minimum standards approach does not go far enough and that a federal chartering law should be adopted "applying federal standards consistently to all facets of corporation law."

Bills were introduced in 1980 that would have significantly increased the federal regulation of corporations. These bills were not enacted, however.

Also, in a 1992 article Professor Bebchuk argues that "state competition may well produce socially undesirable results whenever a corporate law issue involves significant externalities." He suggests that "it may well be desirable to adopt federal law rules—or at least federal minimum standards—with respect to [issues involving]" significant externalities such as the regulation of takeovers and proxy

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482 Id. at 701.
483 Id.
484 Id. at 702
contests, the protection of creditors, disclosure regulation, and the protection of constituencies other than providers of capital.\footnote{488}

The proposal here for a federal rule mandating a change of control board does not go nearly as far as these prior federal proposals. The proposal here is focused on transactions in which there is compelling evidence that boards, even if acting through independent directors, are not performing in a manner that maximizes shareholder welfare. Further, the proposal here is only a default rule; shareholders can elect not to have the provision apply or can elect to have the provision only apply in certain circumstances, such as hostile tender offers. Thus, the approach increases the competition for corporate governance rules.

C. Criticisms of the Cary Approach

1. The Basic Criticism

In 1985, Professor Fischel in a criticism of the Delaware Supreme Court's decision in the Smith v. Van Gorkom\footnote{489} case wrote:

Delaware corporate law has had its critics, most significantly Professor William Cary, who wrote a famous article attacking Delaware a decade ago [referring to Cary, Federalism]. But today, Cary's position has been discredited; indeed, in recent years it has been discussed only as an illustration of how it is possible to reach the wrong conclusions if one lacks a basic understanding of the economic structure of the corporation and of corporate law.\footnote{490} (emphasis added).

This harsh indictment of Professor Cary's position was first set out by Professor Fischel in a 1982 article in which he argued that Delaware was successful in attracting corporations because its corporate law represented a "climb to the top," not a "race to the bottom."\footnote{491} He asserts that "all available theo-
retical and empirical evidence” contradicts Professor Cary’s position and supports the proposition that “states such as Delaware have adopted enabling corporation statutes to allow private parties to enter into contractual arrangements that they find mutually advantageous.”492

Also, Professor Fischel continues the argument in his 1991 book (with Judge Easterbrook), The Economic Structure Of Corporate Law.493 There the authors wrote: “As a matter of theory, the ‘race for the bottom’ cannot exist. Empirical studies confirmed the force of competition.”494 Professor Roberta Romano, in her 1993 book The Genius of American Corporate Law495 strongly supports this position in a chapter entitled The Federalism Debate.496

A close analysis of the authorities relied on by Professor Fischel shows that he has overstated the case against Professor Cary’s position. He and Judge Easterbrook do not give appropriate consideration to an empirical study by Professors Bradley and Schipani that directly supports Professor Cary’s position. Also, a close review of Professor Romano’s more refined analysis of this issue leads to the conclusion that there is substantial empirical support for Professor Cary’s “race to the bottom” theory.

2. The Empirical Support for the Criticism

The sole piece of empirical evidence relied on by Professor Fischel in his Race to the Bottom article was a 1982 study by Professors Dodd and Leftwich497 in which they “investigate the case for federal chartering of corporations by examining evidence of the effect of the choice of a state of incorporation on the wealth of shareholders.”498 In their 1991 book, Professor Fischel and Judge Easterbrook also cite to this study by Dodd and Leftwich, as well as to studies by Professor Romano and by

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492 Id. at 921.
494 Id. at 214.
495 ROMANO, supra note 391, at 14-24.
496 Id. at 14-24.
497 Fischel, supra note 475, at 920-21.
Professors Baysinger and Butler, as support for the statement that “[e]mpirical studies confirmed the force of competition.”

Professors Dodd and Leftwich argue that if Professor Cary’s position were correct, firms would earn negative abnormal returns when “managements initiate a change in the state of incorporation to a state that is supposedly more pro-management (such as Delaware).”

Rather than finding abnormal negative returns, they find that reincorporations generally follow a period of abnormal positive returns and that after the reincorporation shareholders earn normal returns. They argue that these findings are inconsistent with Professor Cary’s position, which they refer to as the “stockholder-exploitation hypothesis” and are consistent with the “cost-avoidance hypothesis.” They conclude that “contrary to the allegations of the supporters of federal regulation, stockholders are not made worse off when firms switch state of incorporation, even when they switch to that much-maligned state of Delaware.” They continue:

"[T]he case for federal chartering is not supported by the evidence. The evidence is consistent with our hypothesis that managers of a firm take advantage of the competition among states to locate in a state which offers an efficient set of restrictions on the firm, given the firm’s anticipated production-investment and financing decisions."

The empirical findings in the Dodd and Leftwich study were refined in a 1985 empirical analysis of the “incorporation puzzle” by Professor Roberta Romano. Professor Romano

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499 EASTERBROOK & FISCHEL, supra note 493, at 214.
500 Dodd & Leftwich, supra note 498, at 261.
501 Id. at 275.
502 Id. at 281.
503 Id. at 282.
divides reincorporations into the following three categories: (1) reincorporations by target firms to take advantage of defensive tactics; (2) reincorporations by acquiring firms to better effectuate mergers and acquisitions; and (3) reincorporations for other purposes, such as the achievement of tax savings. She finds that on an aggregate basis, reincorporations produced positive abnormal returns of 4.1% and on a disaggregated basis each category produced the following positive abnormal returns: (1) merger and acquisitions—8.6%; (2) defensive tactics—1.3%; and (3) other reasons—0.6%. She finds that only the positive returns for mergers and acquisitions are statistically significant.

It is possible that Professor Romano’s finding that reincorporations by acquiring firms produce positive abnormal returns is consistent with Professor Cary’s theory. If the shareholders of potential acquirors benefit from reincorporations, it may be attributable to the expectation that the reincorporation will better position the acquiror to gain an advantage in dealing with the target’s shareholders. Thus, a finding that the shareholders of reincorporating acquirors experience positive abnormal returns may be an indication that the shareholders of potential targets of the reincorporating acquirors experience offsetting negative abnormal returns reflecting the increased possibility that the acquirors may be in a better position to exploit the target’s shareholders. If the abnormal returns for reincorporations for the purposes of mergers and acquisitions and of defensive tactics are ignored, the reincorporations for other purposes produce a statistically insignificant positive abnormal return of only 0.6%. If these reincorporations could be unbundled to focus only on those that are effectuated for the specific purpose of engaging in one of

505 Romano, Incorporation Puzzle, supra note 504, at 270.
506 Id. at 271.
507 Id. at 272-73.
508 Cary, supra note 481, at 700-01.
the transactions that Professor Cary has criticized, one might find negative abnormal returns. I do not find Professor Romano’s study to be strongly supportive of either the Fischel/Easterbrook position or the Cary position.

In the article by Professors Baysinger and Butler, cited by Professor Fischel and Judge Easterbrook, the authors contend that since investors can choose to invest in corporations that are incorporated in states with strict fiduciary rules, “[a] uniform strict law would not benefit these shareholders. On the other hand, shareholders who prefer liberal laws would be denied a choice and thus injured.” In any event, because of the election-out possibility, the change of control board concept is not a “uniform strict law.”

3. The Empirical Support for the Cary Position

It would appear that Professor Fischel and Judge Easterbrook have overstated the empirical support for their race to the top theory. Also, they do not adequately address the 1989 empirical study by Professors Bradley and Schipani, which provides just the type of focused study of the market response to a specific legal rule that would be encompassed by Professor Cary’s proposal for federal minimum fiduciary standards. In their study, Professors Bradley and Schipani examine, through the mechanism of event studies, the market impact on the shares of Delaware firms as a result of the following two events. The first event was the Delaware Supreme Court’s decision in Van Gorkom, in which directors were held personally liable for breach of the duty of care. The second event was the subsequent legislative response by enactment of section 102(b)(7) of the Delaware Business Corporation Law, which permits corporations to limit or eliminate monetary damages faced by directors for breach of the duty of care.

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510 Bradley & Schipani, supra note 372, at 69.
511 Id. at 57-59. Professors Bradley and Schipani also examine the market impact of these two events on insurance companies providing directors and officers insurance. This aspect is not examined here.
Professors Bradley and Schipani explain that since Van Gorkom increases legal constraints placed on directors and section 102(b)(7) loosens these restraints, Van Gorkom and section 102(b)(7) "provide an opportunity to test empirically the relative importance of market constraints and legal constraints to shareholder wealth." They set out the following alternative hypotheses regarding the Van Gorkom decision:

If the constraints imposed by the due care standard are important monitoring devices designed to keep management interests aligned with shareholder interests, we expect to see shareholder wealth increase in the wake of the [Van Gorkom] decision. Stronger liability rules are predicted to favor absentee stockholders. Alternatively, if market constraints are sufficient to prevent the interests of managers from diverging from those of shareholders, the tightening of legal constraints would unduly restrict management's ability to perform. Shareholder wealth would thus decrease.

And, Professors Bradley and Schipani set forth the following alternative hypotheses regarding the enactment of section 102(b)(7):

[T]o the extent section 102(b)(7) permits greater managerial discretion, the legal constraint theory predicts a decrease in shareholder wealth. The lack of monitoring would increase the incentives of directors to ignore shareholder interests and act in their self-interest. Conversely, the market constraint theory predicts that in lessening the constraints imposed on management decisionmaking, section 102(b)(7) should favorably affect shareholder wealth.

Professors Bradley and Schipani find "no significant change in the value of Delaware firms around the date of the [Van Gorkom] decision." They go on to conclude:

[Contrary to either the market [Fischel] or the legal constraint [Cary] theories, [Van Gorkom] does not appear to have

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514 Bradley & Schipani, supra note 372, at 44.
515 Id. at 44-45.
516 Id. at 46.
517 Id. at 58.
had a significant effect on the stock price of Delaware corporations vis-à-vis corporations incorporated in other states. . . . One possible reason is the persuasive value of Delaware case law on the corporate law of other states.518

On the other hand, they find a "significant decrease in the relative values of Delaware firms in the wake of section 102(b)(7) . . . ."519 They explain that this decrease in value "indicates that the relaxed liability exposure for violations of the duty of care standard allowed by this act is detrimental to the wealth of the stockholders of Delaware firms."520 The results are consistent with the legal constraint view that the enactment of section 102(b)(7) increased agency costs and reduced the value of the shares of these firms. They also found negative abnormal returns for firms adopting the limited liability provided by section 102(b)(7).521

Finally, Professors Bradley and Schipani address the significance of their findings on the debate between Professor Cary's "race to the bottom" theory and Professor Fischel's "climb to the top" theory:

The negative economic effects incurred in the wake of Delaware's enactment of section 102(b)(7) are more consistent with William Cary's thesis that competition among states can be characterized as a race to the bottom. We end by noting that since July 1, 1986, the effective date of the Delaware statute, 37 states have enacted similar legislation.522

The findings of Professors Bradley and Schipani are not controverted and arguably are essentially confirmed by an empirical study by Professors Janjigian and Bolster of the performance of Delaware firms during the legislative period leading up to the enactment of section 102(b)(7).523 Although they conclude that "liability elimination does not have a significant

518 Id. at 59.
519 Bradley & Schipani, supra note 372, at 61.
520 Id.
521 Id. at 63.
522 Id. at 72.
impact upon shareholder wealth," they also point out that "results indicate that Delaware firms performed worse than non-Delaware firms during the Delaware legislature's debate and approval of the liability-eliminating measure." Their overall conclusion, however, is that "no systematic evidence is found indicating that . . . limitations on liability negatively affect shareholder wealth."

The findings of Bradley and Schipani are essentially supported by an empirical study of the effects of the enactment of section 102(b)(7) by Professor Romano. She finds statistically significant abnormal negative returns on the day after the press reports of the enactment of section 102(b)(7) and on the day after the Senate passed the legislation. She says that her "findings are broadly consistent with Bradley and Schipani's finding of significantly negative cumulative abnormal returns upon the effective date of the statute . . . ." Notwithstanding these findings she concludes: "Given the curious pattern of the CARs as well as the odd timing of the only significant CARs, the event study data provide no convincing support for a perceived deterrent effect from directors' liability for negligence." She criticizes the Bradley and Schipani study's findings of negative abnormal returns on the effective date of section 102(b)(7) because she argues that the effective date, which was two weeks after enactment, is essentially irrelevant for determining shareholder reaction. She points out, however, that "there is also no other obvious event

\[524\] Id. at 60.
\[525\] Id. at 59. Also, in a study of the shareholder wealth effects of charter amendments by Delaware corporations to expand management protection by limiting directors' liability under section 102(b)(7) and increasing indemnification rights, Professors Netter and Poulsen find that "cumulative abnormal returns are negative for high insider ownership firms . . . ." Jeffrey Netter & Annette Poulsen, State Corporations and Shareholders: The Recent Experience, FINANCIAL MANAGEMENT, Autumn 1989, at 29, 38.
\[526\] Janjigian & Bolster, supra note 523, at 59.
\[527\] Roberta Romano, Corporate Governance in the Aftermath of the Insurance Crisis, 39 EMORY L.J. 1155, 1160 (1990).
\[528\] Id. at 1186.
\[529\] Id. at 1187.
\[530\] Id. at 1187-88.
\[531\] Id. at 1185.
that could have affected Delaware firms on the later dates and that thereby would explain the negative returns.\textsuperscript{532}

In her 1993 book, \textit{The Genius of American Corporate Law}, Professor Romano summarizes the results of the three studies of the effect of the enactment of section 102(b)(7) as follows:\textsuperscript{533}

\begin{center}
\begin{tabular}{|l|l|}
\hline
Bradley and Schipani (1989) & Negative AR\textsuperscript{*} on effective date \\
Janjigian and Bolster (1990) & Negative AR on newspaper announcement day and day of introduction to Senate \\
Romano (1990) & Negative AR on effective date, day after Senate action \\
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\end{tabular}
\end{center}

\textsuperscript{*}AR = Average Residual or Abnormal Return

She also reports that four studies of the effect of the adoption by firms of section 102(b)(7) charter provisions produce ambiguous results.\textsuperscript{534} She points out that "[e]vent studies of charter amendments may not, however, accurately identify an amendment's effect if investors anticipate that firms will adopt conforming charter amendments when the enabling statute is enacted."\textsuperscript{535} Although this analysis would seem to give credence to the consistent findings of negative abnormal returns around the date of enactment of section 102(b)(7) (which forcefully support Professor Cary's thesis), Professor Romano nevertheless concludes, "[t]he most cogent interpretation of these data is that the limited liability statute did not adversely affect shareholders, a conclusion more consistent with Winter's than Cary's characterization of state competition."\textsuperscript{536}

I read the empirical evidence regarding section 102(b)(7) as strongly supportive of the Cary thesis, and Professor Romano reads the evidence as unsupportive. However, with regard to the empirical evidence concerning the economic impact of state

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\textsuperscript{532} Romano, \textit{supra} note 527, at 1187. \\
\textsuperscript{533} ROMANO, \textit{supra} note 391, at 20. \\
\textsuperscript{534} \textit{Id.} \\
\textsuperscript{535} \textit{Id.} at 22. \\
\textsuperscript{536} \textit{Id.} at 24.
\end{flushright}
takeover legislation, such as control share statutes, she con-
cludes that "[e]mpirical research on the effects of [state] take-
over laws on shareholder wealth is most consistent with Cary's
view of the harmful effect of state competition."537

Given that the general thrust of both section 102(b)(7) and
state takeover statutes is to protect incumbent directors and
that the enactment of these provisions was accompanied by
significant abnormal shareholder returns, the empirical evi-
dence seems overwhelmingly supportive of Professor Cary's
thesis. This is so even though, as Professor Romano points out,
the "[e]vent studies of Delaware's second-generation statute
find no significant price effect . . . [which] is consistent with
viewing Delaware's efforts at regulating takeovers as less re-
strictive than those of other states."538 Indeed, this is an illus-
tration that, in the context of state takeover legislation, states
such as Pennsylvania that have enacted highly restrictive pro-
visions have harmed shareholders,539 whereas Delaware, with
its less restrictive takeover provision, section 203, and its
Unocal enhanced scrutiny of defensive tactics, has been more
protective of shareholder rights.540 This observation is, of
course, consistent with Cary's general thesis that the protection
of shareholder rights is beneficial.

A study by Professor Robert Daines provides additional
empirical support for the proposition that in the takeover area
Delaware law is more efficient than the law of many other
states.541 Using a Tobin Q analysis, Professor Daines finds
that "Delaware firms are worth more than similar non-Delaware
firms."542 Professor Daines explains that Tobin's Q provides
an estimate of a company's market value divided by the
company's replacement cost and that the "ratio represents a
firm's investment or growth opportunities, including those

537 Id. at 60.
538 ROMANO, supra note 391, at 67.
540 See Delaware Business Corporation Law, DEL. CODE ANN. tit. 8, § 203
1985).
541 Robert Daines, Does Delaware Law Improve Firm Value?, Nov. 1999, avail-
able in Social Science Research Network Electronic Library, <http://
542 Id. at 4.
added by management and corporate law rules." In addressing why Delaware law "may add value," Professor Daines says that the

best view of the evidence is that Delaware corporate law improves firm value by facilitating the sale (acquisition) of the firm. First, Delaware law is less likely than other states to entrench incumbent managers due to its takeover law, political economy and specialized corporate courts. . . . Delaware firms receive significantly more takeover bids and are significantly more likely to receive at least one bid and to be acquired. Firms in states that raise significant barriers to hostile bids are worth less and receive significantly fewer bids.

Professor Daines goes on to conclude that Delaware "produces legal rules and courts that appear to improve firm value."

I would like to make three observations about Professor Daines' findings: First, the findings do not show that Delaware law is optimal and cannot be improved upon; the findings merely show that Delaware law is more economically efficient than the laws of other states. Second, the Cary thesis would clearly support Delaware law over the restrictive anti-takeover provisions adopted by many states, and the growth of restrictive state takeover statutes is just another variant of the race to the bottom. Third, the adoption of the change of control provisions proposed here would certainly be an improvement over both the restrictive state takeover laws and the less restrictive Delaware law.

Finally, Professor Fischel and Judge Easterbrook pose the question: "Does the 'race for the top' survive the adoption of antitakeover statutes?" They respond that the "answer depends on how the thesis is characterized." They say, on the one hand, that "[i]f the claim is that the competition among states for incorporations always produces the optimal result, it

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543 Id. at 10.
544 Id. at 5.
545 Id. at 6.
546 Id. at 5.
547 Id. at 6.
548 EASTERBROOK & FISCHEL, supra note 493, at 222.
549 Id.
stands refuted. On the other hand, they argue that "if the thesis is that competition creates a powerful tendency for states to enact laws that operate to the benefit of investors (the opposite of the Cary view), it is alive and well." They do not explain why, in the face of this "powerful tendency," states would rush to enact anti-takeover laws that in their view are antithetical to shareholder interests.

In any event, it is not necessary to delve further into this dilemma; it is sufficient to note that the proposal here would preempt state takeover statutes because the change of control boards would have sufficient authority to accomplish the purposes of those statutes in appropriate circumstances.

4. Summary

In summary, the theoretical case made by Professor Fischel and others against Professor Cary's position is at bottom based on the false assumption that public shareholders are on an equal bargaining footing with managers and that the resulting bargain between shareholders and managers is in the best interest of both parties. Their theory ignores the real life potential for managerial exploitation of the "rational ignorance" of public shareholders. Thus, their theory closes its eyes to the unlevel playing field between public shareholders and managers.

Although Professor Fischel may have been correct when he said in 1982 that "not one shred of empirical evidence has been adduced to support [Professor Cary's] view," he could not make that statement today. The study of reincorporations by Dodd and Leftwich may on its face support Professor Fischel's theoretical position, but the more focused reincorporation study by Professor Romano called into question the unqualified conclusions reached by Dodd and Leftwich. Further, the even more focused study of the effects of the enactment of section 102(b)(7) by Bradley and Schipani, (and arguably by Janjigian and Bolster, and Romano) provide vigorous empirical

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548 Id.
549 Id.
550 Fischel, supra note 475, at 914.
551 Dodd & Leftwich, supra note 498, at 260.
552 Romano, State Competition Debate, supra note 504, at 732.
support for Professor Cary's position. Thus, the state of the empirical evidence has come full circle.

Also, the race to the top theory is under assault at the theoretical level. In his 1992 article Professor Bebchuk asserts that the capital market, the product market, the market for managers and the market for corporate control, which Professor Fischel assumes will police managers, are not effective in dealing with significant redistributive issues. These are issues in which the size of the potential transfer from shareholders to managers (the distributive element) is significant relative to the potential effect on overall value (the efficiency element). Thus, these situations arise where a particular action by a manager may give rise to a large personal windfall but have a small effect on overall firm value. Professor Bebchuk explains:

The markets for corporate control, managerial labor, additional capital, and company products discipline managers' decisions to some extent. The operation of these markets may well ensure that managers will seek (and states in turn will provide) only value increasing rules with respect to issues that are not significant redistributive. However, . . . the various market forces invoked by race for the top adherents do not ensure that managers will not seek value-decreasing rules with respect to other types of issues. In particular, market discipline notwithstanding, managers may seek such rules with respect to issues that are significantly redistributive.

The "omnipresence" of conflicts of interests in mergers and acquisitions is in large measure attributable to the significant redistributive issues embedded in such transactions. The proposal here for a change of control board would (unless the independent shareholders elect-out) put the control of all significant redistribution issues arising in the context of a change of con-

553 Bradley & Schipani, supra note 372, at 70.
554 Bebchuk, supra note 487, at 1461.
555 Id.
556 For a discussion of a manager's role in the development of corporate law rules, see Carney, Competition for Corporate Charters, supra note 472, at 303-06.
557 Bebchuk, supra note 487, at 1467.
trol of publicly-held corporations in the hands of a truly independent arbiter.

Finally, in a 1999 article entitled Federalism and Takeover Law: the Race to Protect Managers from Takeovers, Professors Bebchuk and Ferrell make a powerful argument that the "supporters of state competition—Ralph Winter, Frank Easterbrook, Daniel Fischel and Roberta Romano" should reconsider their position. The authors say that "[w]hile the pro-state competition view has a serious problem accounting for existing state takeover law . . . the view that Cary held, and that we are advocating, has no problem whatsoever explaining this." They draw the following conclusions on the race to the bottom theory:

On some important issues, states might have incentives to provide rules that are attractive to managers but not shareholders. Takeover law is one important area in which state competition is likely to fail. There are strong theoretical reasons to expect that state competition will work to produce a body of corporate law that excessively protects incumbent managers. The development of state takeover law . . . is consistent with this view. It should lead the many [including Easterbrook, Fischel, and Romano] who offer unqualified support of state competition to reassess their position.

VII. SURVEY OF OTHER PROPOSALS FOR ADDRESSING CHANGE OF CONTROL TRANSACTIONS AND COMPARISON WITH CHANGE OF CONTROL BOARD

A. Survey

This section surveys many of the other proposals for addressing various types of change of control transactions. This section does not, however, provide an exhaustive review of the proposals in this area.

On the free market side, Professor Fischel and Judge Easterbrook have argued that a target's board should not be

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558 Bebchuk & Ferrell, supra note 3.
559 Id. at 1194.
560 Id. at 1198.
561 Id. at 1199.
able to engage in any defensive action. This view is known as the managerial passivity approach and is based on the assumption that this system will maximize aggregate shareholder value because there will be a larger number of tender offers than would otherwise occur if managers undertake defensive actions.

On the other hand, Martin Lipton has argued strenuously for a standard that permits a target's directors to use defensive tactics and that provides them protection under the business judgment rule. This standard is similar to (but less demanding than) the standard that applies under current Delaware law and under the ALI's proposed rules, both of which provide an enhanced business judgment rule standard of review for defensive actions. Also, under certain state corporate laws, such as the Pennsylvania corporate law at issue in *Norfolk Southern Corp. v. Conrail*, a target's directors have very broad latitude to oppose a hostile takeover, even broader in some cases than the business judgment rule.

As an intermediate position, Professor Bebchuk has argued that in the face of a hostile takeover, a target's board should have to auction the target. In a paper that is soon to be published in the *Virginia Law Review*, Professors Bebchuk and Ferrell propose the adoption of an elective federal takeover law that would not be as protective of management as current state law. Their proposal is broadly consistent with the proposal set out here.

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562 EASTERBROOK & FISCHEL, supra note 493, at 171-74.
565 See Thompson, supra note 2, at 236.
Martin Lipton has also made two legislative proposals for dealing with hostile takeovers and corporate governance in general. In a 1987 article, Lipton laid out a comprehensive legislative plan for addressing hostile takeovers, and he said that if this plan is adopted, defensive tactics could be prohibited. The first part of his legislative proposal would amend the Williams Act to eliminate partial bids by requiring an acquiror in a tender offer to bid for all of a target’s stock. No more than 5% of a target’s stock could be purchased without making a tender offer for all of the stock. Further, the threshold for open market purchases that must be reported under section 13(d) of the Securities Exchange Act of 1934 would be reduced from 5% to 2%. The period during which a tender offer would have to remain open would be extended from the current 20 business days to 120 calendar days to “give the board a realistic opportunity to determine whether the target is best served by remaining independent. . . .” To eliminate what he describes as “an element of coercion in every tender offer,” the target’s shareholders would have the right to vote on the tender offer within the 120 day period. If the bidder did not receive a majority vote, it would have to withdraw its bid.

In addition, Lipton proposes that junk-bond financed bust-up takeovers be discouraged by denying the deductibility for the interest on junk bonds issued to finance hostile takeovers or to repurchase a company’s own equity. To discourage institutions from holding investments for the short-term, he proposes a graduated tax on investment gains that would go from 60% on positions held for not more than one year declining to 35% on positions held for more than five years.

Lipton states that if these proposals were adopted, “the takeover defenses currently used to combat such abuses will no

570 Lipton, Finance Corporatism, supra note 564.
571 Id. at 64-65.
572 Id. at 61.
573 Id.
574 Id.
575 Lipton, Finance Corporatism, supra note 564, at 62.
576 Id.
577 Id. at 63.
578 Id.
579 Id. at 64.
longer be justified." Specifically, he proposes an exchange rule requiring one share, one vote; annual election of directors; and a prohibition against staggered boards and shark repellant charter provisions. Lipton concludes, "[w]ith limitations on abusive takeovers in place, there no longer will be a justification for structural defenses that treat common stockholders unequally or are triggered by a change of control, such as poison pills, lock-up options, and fair-price provisions."

Professor Lowenstein has made a similar legislative proposal. He has proposed that hostile tender offers be required to remain open for at least six months and that any defensive tactics employed by the target's directors be required to be approved by the shareholders.

Although Martin Lipton proposes annual election of directors in the 1987 article, to facilitate long term operating success, in a 1991 article he proposes, inter alia, that directors serve for a five-year period. Specifically this proposal would:

[R]eplace annual elections of directors with quinquennial elections; bar nonconsensual changes in control between elections; provide major stockholders with direct access to the corporate proxy machinery in connection with the quinquennial election; provide for a detailed five-year report, which would be independently evaluated by an outside advisor . . . ; and tie significant management compensation awards, as well as significant penalties, to the corporation's performance against the five-year plan.

He goes on to point out that under this proposal the "quinquennial election would be the sole means of accomplish-

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560 Lipton, Finance Corporatism, supra note 564, at 64.
561 Id. at 65.
562 Id.
564 Id. at 255.
565 Lipton, Finance Corporatism, supra note 564, at 65.
567 Id. at 190.
ing nonconsensual changes of control." There would be a prohibition against an acquisition of more than 10% of a corporation’s stock without the directors’ approval. Between meetings, a corporation’s directors could enter into a consensual acquisition. Since hostile transactions would be prohibited except in connection with the quinquennial meetings, takeover defenses, including the poison pill, would be eliminated and takeover-related state legislation would be prohibited.

In a 1996 article, Professor McGinty proposed that a public corporation’s shareholders be given the authority to initiate voluntary dissolution proceedings. If a majority of the shareholders approved the dissolution, the board of the corporation would be required to obtain the highest value by auctioning the corporation. He sees this voluntary dissolution procedure as the antidote to sophisticated takeover defenses that put shareholders at the “mercy of managers, who can remove the market’s most serious constraints on managerial inefficiency [i.e., the hostile takeover] and, in effect, entrench themselves.” Professor McGinty points out that his proposal is compatible with a proposal made by Bratton and McCahery which would give shareholders the authority to “initiate charter amendments dealing with corporate process and structure.”

Professor McGinty would have a quinquennial opt-out election pursuant to which the shareholders would choose to waive or retain the right to initiate a voluntary dissolution. The default rule would be the opt-out. He says that this opt-out is consistent with both a proposal by Professor Coffee that would require supermajority charter provisions to be reviewed every three years by a similar, supermajority shareholder vote, and a proposal by Professor Romano that would per-

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568 Id. at 240.
569 Id. at 241.
570 Id. at 244.
571 Lipton & Rosenblum, supra note 586, at 241.
573 Id. at 987.
574 Id. at 986-87.
576 McGinty, supra note 592, at 1071.
577 Id.
578 Id. at 1072 n.229. See John C. Coffee, Jr., Regulating the Market for Corpo-
mit shareholders to opt-out of the Williams Act if they do not want their corporation to hold auctions, thereby increasing the possibility of takeover, but possibly at a lower premium. 599

Professor McGinty distances his proposal from Martin Lipton’s quinquennial election proposal, which the professor describes as “unappealing because it follows essentially a socialist, or at least command economy, model for running free market firms” and it reduces “directors’ discretion to respond to changing conditions [thereby] discard[ing] the dynamic responsiveness of capitalist forms of organization.” 600

Professor Weiss has proposed that the Williams Act be amended to incorporate certain provisions of Delaware’s business combination statute. 601 This statute prohibits second-step freezeout mergers for a three-year period after a hostile acquiror acquires more than 15% of a target’s stock, unless: (1) the acquiror acquires 85% of the target’s stock, (2) before the acquisition the target’s board approves the acquisition, or (3) after the acquisition the target’s board and two-thirds of the disinterested shareholders approve the transaction. 602 His proposal would preempt both state antitakeover statutes and most takeover defenses. 603

Finally, in a 1998 article, Professor Romano proposes a “regulatory approach of competitive federalism, under which firms select their securities regulator from among the fifty states and the District of Columbia, the SEC, or other nations.” 604 Thus, she would permit a corporation to elect-out of the Securities Act of 1933 and the Securities Exchange Act of 1934, including the Williams Act. Without commenting on the general merits of this proposal, the change of control board concept is broadly consistent with the general thrust of her


599 McGinty, supra note 592, at 1072 n.229. See Romano, supra note 183, at 165-66 (proposing amendments to Williams Act).

600 McGinty, supra note 592, at 1072 n.229.


603 See Weiss, supra note 601, at 1700.

proposal because a company could elect-out of the change of control provision and thereby be governed by the law of the jurisdiction of incorporation.

B. Comparison of Other Proposals With the Change of Control Board Concept

The proposal here for a change of control board would address many of the concerns that motivate these various proposals. Indeed, the change of control board concept has the flexibility in a particular context to accommodate the polar opposite positions of the managerial passivity approach of Easterbrook and Fischel or the managerial action approach of Lipton. In certain circumstances, the change of control board may decide to take no defensive action and let the shareholders decide, as proposed by Easterbrook and Fischel. In other circumstances, it may erect a "just say no" defense, which is consistent with Lipton's approach. Of course, if the circumstances require, the change of control board could adopt the intermediate auction approach of Bebchuk. The point is that the optimum approach (managerial passivity, managerial action, auction, or other) will depend on the circumstances, and the change of control board has the authority and the expertise to fashion an appropriate response.

The change of control board is more flexible than Lipton's legislative proposal of a 120 day tender offer period with the target's shareholders having the right to vote on the tender offer. Lipton's proposal would unnecessarily delay transactions that for good business reasons need to close quickly. Also, if the change of control board wanted to have a shareholder vote it could provide for one. For the same reasons, the change of control board concept is more flexible than Professor Lowenstein's proposal for a six month tender offer period and for shareholder approval of defensive tactics. If in a particular case a change of control board wanted to seek shareholder approval of any defensive tactics it undertook, it could do so.

The change of control concept is obviously more flexible than the quinquennial election proposal made by Lipton. It would be unwise to insulate a corporation from the potential of a hostile acquisition for any period, let alone for five years, as his proposal would do. Also, Lipton's proposal would unfairly
strengthen the hand of a corporation's board because it could, within the five-year period, enter into consensual transactions.

Because the change of control board concept would not act as a deterrent to takeovers, there would be no reason to give the shareholders the right to initiate dissolution procedures, as Professor McGinty has proposed. Also, since shark repellent charter provisions would be prohibited, it would not be necessary to get a shareholder vote on such provisions as Professor Coffee has proposed. Professor Weiss's proposal for a federal statute similar to Delaware's business combination statute would not be needed with the change of control board concept. Finally, the adoption of Professor Romano's proposal for an elective securities law regime should not have an adverse effect on the adoption of the change of control board concept.

In summary, the change of control board concept provides for great flexibility in responding to the dynamic market for corporate control. It does not provide a set of rigid rules, which, depending on the circumstances, may or may not maximize shareholder welfare. Finally, all of the surveyed proposals are directed at hostile acquisitions, but the change of control board concept applies to all forms of change of control transactions involving public corporations: arm's-length mergers and acquisitions, management buyouts, tender offers, and freezeouts.

VIII. COMPARISON OF CHANGE OF CONTROL BOARD CONCEPT WITH RULES GOVERNING A TARGET'S DIRECTORS, IN THE UNITED KINGDOM, GERMANY, AND THE EUROPEAN UNION

The approach to takeover regulation in the United Kingdom and Germany and the proposed takeover regulation of the European Union are significantly different from the U.S. approach. This is obviously a complex topic, and the discussion here focuses on only the rules governing the defensive actions of the target's board.

In the United Kingdom, takeovers of publicly-held corporations are governed by the City Code on Takeovers and Mergers

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605 See Edward F. Greene et al., Toward a Cohesive International Approach to Cross-Border Takeover Regulation, 51 U. MIAMI L. REV. 823, 824 (1997) (noting that United States regulates takeovers by statute while United Kingdom and Germany regulate through non-statutory bodies); see generally THOMPSON, supra note 324, ch. 26, pt. IV.
(City Code),\textsuperscript{606} which is administered by the Panel on Takeovers and Mergers. The Panel consists of market participants and relies on non-legal sanctions for enforcement. The City Code consists of general principles and specific rules, including rules governing Substantial Acquisitions of Shares (SARs).

General Principles 7 of the City Code prohibits the target's board from taking defensive actions after the commencement of a takeover bid without the prior approval of the target's shareholders:

At no time after a bona fide offer has been communicated to the board of the offeree company [the target], or after the board of the offeree company has reason to believe that a bona fide offer might be imminent, may action be taken by the board of the offeree company in relation to the affairs of the company, without the approval of the shareholders in general meeting, which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits.\textsuperscript{607}

General Principle 9 provides in part that when giving advice to the shareholders the directors should consider the "shareholders' interest taken as a whole, together with those of employees and creditors."\textsuperscript{608}

Rule 3.1 of the City Code provides that the "board of the offeree company must obtain competent independent advice on any offer and the substance of such advice must be made known to its shareholders."\textsuperscript{609}

Germany follows a similar approach in The German Takeover Code.\textsuperscript{610} Article 19, under the General Principles of this code, provides: "Following publication of a public tender offer, and until the outcome of the tender offer is published, the exec-

\textsuperscript{606} PANEL ON TAKEOVERS AND MergERS, CITY CODE ON TAKEOVERS AND MergERS AND THE RULES GOVERNING SUBSTANTIAL ACQUISITIONS OF SHARES (9th ed. 1996) [hereinafter CITY CODE]; see generally, THOMPSON, supra note 324, § 26.9.B.

\textsuperscript{607} CITY CODE, supra note 606, at General Principle 7.

\textsuperscript{608} Id. at General Principle 9.

\textsuperscript{609} Id. at Rule 3.1.

utive or managing body of the target company . . . may not take any measures that run counter to the interest of the holders of securities in taking advantage of the tender offer."

The Article prohibits the following:
(1) the issuance of new securities;
(2) a substantial change to the assets or liabilities of the target company; and
(3) the conclusion of agreements outside of the scope of ordinary business activities.

The European Commission currently has a Takeover Proposal (EC Takeover Proposal), which, if adopted, would establish takeover standards that all members of the European Union would have to adopt. Article 8 of the EC Takeover Proposal provides that member states shall ensure that rules are in force requiring that after receiving the information concerning the bid, and until the result of the bid is made public or lapses:

the board of the offeree company should abstain from completing any action other than seeking alternative bids which may result in the frustration of the offer, and notably from the issuing of shares which may result in a lasting impediment to the offeror to obtain control over the offeree company, unless it has the prior authorisation of the general meeting of the shareholders given for this purpose during the acceptance of the bid . . . .

The December 9, 2000 issue of the Economist reports that the European Parliament’s legal affairs committee has voted to amend the current EC Takeover Proposal to “allow national supervisors to give company boards the right to devise defensive measures [such as poison pills] to deter predators, without

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611 GERMAN TAKEOVER CODE, supra note 610, at art. 19.
612 Id.
613 PROPOSAL FOR A 13TH EUROPEAN PARLIAMENT AND COUNCIL DIRECTIVE ON COMPANY LAW CONCERNING TAKEOVER BIDS, (December 1999) [hereinafter EC TAKEOVER PROPOSAL]. See generally, THOMPSON, supra note 324, § 26.8.C.
614 See generally Greene, Cross-Border Takeover, supra note 605, at 862; THOMPSON, supra note 324, § 26.8.C.
615 EC TAKEOVER PROPOSAL, supra note 613, art. 8.
first obtaining shareholder approval." It is not certain whether this amendment will be finally adopted.

The approach to defense tactics taken by the United Kingdom and Germany and posited in the current draft of the EC Takeover Proposal is similar to the management passivity approach urged by Judge Easterbrook and Professor Fischel. This approach should not be followed for at least two reasons. First, Professors Bradley and Schipani identified a collective action problem whereby, a passive board could permit an acquirer to take unfair advantage of the target's shareholders. Second, there may be times when the market does not reflect the value of the target's assets, and in such cases it may be appropriate for a board to "just say no." For these reasons, the change of control board is superior to the approaches taken by the United Kingdom, Germany, the EC, and Easterbrook and Fischel. The change of control board concept does, however, contemplate the appointment of independent advisors to the board, which is a requirement of Rule 3.1 of the City Code.

There is one final point on the merger proposals of the European Union. In its 1978 Directive Concerning Mergers of Public Limited Liability Companies, the European Commission promulgated a rule which in the acquisition of a public corporation requires: "[o]ne or more experts, acting on behalf of each of the merging companies but independent of them, appointed or approved by a judicial or administrative authority, [to] examine the draft terms of merger and draw up a written report to shareholders." The proposal here extends this EC requirement of expert independence to the target's board.

616 Poisoned?, The Economist, Dec. 9th-15th, 2000, at 82, 82.
617 See Easterbrook & Fischel, supra note 493, at 171-74.
618 Bradley & Schipani, supra note 372.
619 CITY CODE, supra note 606.
IX. ANALYSIS OF NEGATIVE COMMENTS OF SEVERAL MERGER AND ACQUISITION PRACTITIONERS

Several leading merger and acquisition practitioners strongly criticized the change of control board concept. Here, I summarize the general thrust of these critiques and provide a response.

The critique of Martin Lipton, one of the country's preeminent merger and acquisition practitioners, is short and to the point. After saying he does not agree with the change of control board concept, he writes: "In practice, I think this would be the same as the rule of passivity Easterbrook and Fischel argued for in the 80's and which I argued against in our extensive exchange of articles. The rule of passivity received no support and quickly disappeared." It is highly unlikely that a change of control board would stand passive in the face of an acquisition proposal. To the contrary, the change of control board would likely be very active in critically evaluating the plans and prospects of the target under the current board and under the proposals of the acquiror.

Also, the reach of the change of control board concept is much broader than the reach of Easterbrook and Fischel's passivity principle. The passivity rule would apply only in the context of a hostile tender offer, whereas the change of control board concept would apply to any proposal, whether friendly or hostile, to acquire a publicly-held target.

Mr. Lipton goes on to say that he thinks "Delaware has evolved the best approach" and that he supports it. He further says that he is "strongly opposed to any federal role in corporate governance." This opposition to a federal role in corporate governance was also echoed by Marshall L. Small, one of the reporters for the Corporate Governance Project. Mr. Small writes:

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621 Letter from Martin Lipton, Senior Partner, Wachtell, Lipton, Rosen and Katz, to Samuel C. Thompson, Jr., Professor and Director, Center for the Study of Mergers and Acquisitions, University of Miami School of Law. 
622 EASTERBROOK & FISCHEL, supra note 493, at 171-74. 
623 Letter from Martin Lipton to Samuel C. Thompson, Jr., supra note 550. 
624 Id.
I should start my response by disclosing that I am very cautious about trying to solve perceived problems through governmental intervention. My basic philosophy in the area of corporate governance is to encourage governance procedures in the private sector that will create a credible climate of corporate accountability to shareholders and the other constituencies served by the business community. Accordingly, when you broached the idea of a government appointed control board, I was initially skeptical but willing to consider objectively your proposal. Having now read your draft article and your proposed Section 14A of the Exchange Act, my views have not changed, and I must advise you that I think the proposal is a bad idea.\(^{625}\)

Dennis S. Hersch, the head of the mergers and acquisitions department at Davis Polk & Wardwell, makes a similar point regarding governmental intervention: "I submit that the kinds of decisions that directors must make in change of control transactions cannot—and should not—be delegated to some appointed bureaucrat . . . ''.\(^{626}\)

In response to these governmental intervention points, there is currently substantial governmental intervention in the merger and acquisition market through the widespread adoption of state takeover laws, which would be preempted by Proposed Section 14A(m)(2) of the Securities Exchange Act of 1934. Also, the substantial litigation in the merger and acquisition market is a form of governmental intervention. For example, Herbert Wachtell, a leading takeover litigator, says,

\[\text{[t]}\text{akeover litigation is unique [and] . . . [y]ou have to commence litigation immediately. You have to get out your deposition notices. You have to make your motions for expedited discovery . . . . You have to be scheduling your applications for temporary restraining orders, stays, preliminary injunctions and the like.}\] \(^{627}\)

\(^{625}\) Letter from Marshall L. Small, Senior of Counsel, Morrison & Foerster, to Samuel C. Thompson, Jr., Professor and Director, Center for the Study of Mergers and Acquisitions, University of Miami School of Law (Feb. 25, 1998).

\(^{626}\) Letter from Dennis S. Hersch, Panter, Davis, Polk & Wardwell, to Samuel C. Thompson, Jr., Professor and Director, Center for the Study of Mergers and Acquisitions, University of Miami School of Law (Feb. 10, 1998).

\(^{627}\) Herbert M. Wachtell, Special Tender Offer Litigation Tactics, 32 BUS. LAW.
Adoption of the change of control board concept should dramatically reduce the amount of takeover related litigation, thereby reducing judicial interference in the market for corporate control.

Further, under the change of control concept, decisions would not be made by an “appointed bureaucrat” but rather by experienced and independent members of the change of control board who are appointed on an objective basis by a Change of Control Official, who has functions quite similar to those of a U.S. Trustee in bankruptcy matters.

With regard to arm’s-length merger and acquisition transactions, Mr. Small says: “I believe that at least in arm’s-length non-hostile merger transactions, current corporate governance mechanisms can successfully resolve any such conflicts.”

Certainly, a target’s board may act appropriately in an arm’s-length, non-hostile merger, but there is also great potential in such transactions for the controlling members of the target’s board to feather their own nests. For example, the target’s board may negotiate significant golden parachutes or employment payments, at the expense of the target’s shareholders. We will never know how many friendly acquisitions have been completed at a price less than the maximum the target’s shareholders could have received.

With regard to management buyouts and freezeouts, Mr. Small argues:

[Even where conflicts are sharper—as in management buyout or cashout of minority shareholders’ transactions—private sector mechanisms available, through use of independent board committees, seem to me to be as effective as any government-appointed board—which must grapple with the same issues as incumbent directors.]

Here, Mr. Small is at odds with former Chancellor Allen of the Delaware Chancery Court who has said that “the jury is still out on the question whether the special committee device

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1433, 1433 (1977).
286 Letter from Marshall L. Small to Samuel C. Thompson, Jr., supra note 625.
287 Id.
works well enough, often enough, for the law to continue to accord it weight.\textsuperscript{630} The change of control board is especially needed in these transactions.

Mr. Small also says, "I believe the use of the control board mechanism, as proposed, will . . . have a chilling effect on merger activity and instead of enhancing shareholder value and providing economic efficiency in the merger market, such a mechanism will in my opinion have exactly the opposite effect."\textsuperscript{631} I believe Mr. Small is wrong on this point. By taking all types of defensive tactics out of the hands of a target's directors, the change of control board concept should facilitate acquisitions and thereby increase the frequency of unwanted transactions. In this regard, it should be noted that, as pointed out by Joe Flom, in an analysis of mergers and acquisitions in the 1990s:

In 1991 there were only two domestic hostile deals announced . . . . In 1998 there were three announced hostile deals . . . . Such transactions substantially increased in number (fifteen transactions) . . . in 1999 . . . . In 1999, announced hostile deals worldwide . . . represent[ed] over 14% of all announced worldwide deal value. This was due, in no small measure, to a precipitous increase in European hostile deals.\textsuperscript{632}

It seems likely that the current takeover rules in Delaware, and in states like Pennsylvania, are depressing the amount of hostile takeover activity. Indeed, it seems curious that in 1999, a year of extremely heavy merger and acquisition activity, there would be only 15 hostile transactions. It is inconceivable that the amount of hostile activity would have been lower in 1999 if the change of control concept had applied.

Mr. Hersch, of Davis, Polk & Wardwell, also says that he has "serious doubts . . . that the types of individuals you envision [for the change of control board] could be found."\textsuperscript{633} Just as there is a market for board members, I believe an active

\textsuperscript{630} Allen, supra note 447, at 2062-63.
\textsuperscript{631} Letter from Marshall L. Small to Samuel C. Thompson, Jr., supra note 625.
\textsuperscript{633} Letter from Dennis S. Hersch to Samuel C. Thompson, Jr., supra note 626.
market would develop for membership on change of control boards, particularly in view of the personal liability protection that these directors receive. There should be no shortage of competent business people, investment bankers, attorneys, and others from around the country who would be more than willing to serve on a change of control board.

Also, Mr. Hersch challenges the premise of this article concerning the inherent conflict corporate directors face in change of control transactions. On this point he says:

[T]he article cites a handful of cases in which directors were adjudged to have acted improperly. Far be it for me to defend the directors of Trans Union or Revlon who clearly did not act in a responsible manner.

The problem I have is that you extrapolate from a small number of cases a proposal that ignores the very fine work done by the overwhelming majority of corporate boards in change of control transactions. I have little doubt that it could be empirically demonstrated that a far greater number of these transactions are completed without legal challenge—or after successfully defending a challenge—than the other way around.

If my own experience is a relevant yardstick, I think you are generally incorrect in your premise that directors do not deal well with conflicts.

He goes on to point out several transactions in which he was involved that demonstrate the effectiveness of the current board structure.

I do not doubt that the current system works well in many cases, and I have no doubt that a “far greater number of these transactions are completed without legal challenge—or after successfully defending a challenge—than the other way around.” This does not mean, however, that in such successful deals the target’s shareholders have received the consideration to which they are entitled. Further, this says nothing about the number of deals that do not happen under the cur-

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634 See supra part III.F.
635 Letter from Dennis S. Hersch to Samuel C. Thompson, Jr., Letter, supra note 626.
636 Id.
637 Id.
rent rules because of the depressing effect of defensive tactics like the poison pill.

The bottom line is that while I have great respect for the professionals who have given me their critiques, I still believe that the change of control board concept would significantly improve the governance of the merger and acquisition process.

X. Conclusion

Under the proposal here, a publicly-held corporation that becomes the target of a merger or acquisition would, unless the public shareholders elected-out, be subject to the change of control provisions of proposed Section 14A of the Securities Exchange Act of 1934. Thus, a uniform federal rule would apply to all such corporations.

Under Proposed Section 14A, a change of control board for a target corporation would be appointed at the time the target becomes the subject of a possible change of control transaction, whether an arm’s-length merger or acquisition, a management buyout, a hostile tender offer, or a freezeout. The change of control board would have complete authority to make all board decisions for the target relating to the transaction, including the implementation of defensive tactics, such as the adoption of poison pills and the making of golden parachute payments. The change of control board would likely consult closely with the current board and the senior management of the target, and one of the members of the change of control board could be a member of the regular board, provided he or she was otherwise qualified.

The members of the change of control board would be appointed by the Change of Control Official, a nonpolitical appointee of the SEC. In making the appointments, the Change of Control Official would be required to make an ex ante decision that the members of the board are truly independent and have the requisite experience in the merger and acquisition process.

Because of this independence and experience, the change of control board would be subject to one governance standard, the business judgment rule, without respect to the type of transaction. There would be no need for separate governance standards for the four different types of change of control transac-
tions as is the case under current Delaware law and as proposed in the Corporate Governance Project.\textsuperscript{638}

The proposal here is much more limited than proposals of Professor Cary and others for a federalization of corporate law. Since the shareholders can elect not to have the provision apply or elect to have it apply in only limited circumstances such as in hostile tender offers, this proposal offers shareholders an additional set of governance rules, thereby increasing the competition for such rules. Also, even after the appointment of a change of control board, the shareholders could, pursuant to SEC rules, elect to dissolve the change of control board and return to governance by the corporation's regular board or another board.

The justification for this proposal is simple. As recognized in several cases involving all types of mergers and acquisitions in the arm's length merger in Van Gorkom, the management buyout in Hanson Trust, the tender offer defensive tactics in Revlon and the freezeout merger in Weinberger, the conflicts facing a target's board, including independent directors, in mergers and acquisitions often lead to decisions that do not maximize shareholder welfare. Also, these same cases illustrate that directors who may be proficient at making entrepreneurial decisions may not have the requisite skill to make decisions that maximize shareholder value in mergers and acquisitions.

The change of control board addresses these two defects in the current process by ensuring the appointment of board members who are both conflict free and knowledgeable. The proposal is designed to ensure that the directors guiding the target through the merger and acquisition process act in the sole interest of promoting the welfare of the target's shareholders and where appropriate, other constituencies.

The cost associated with the change of control board should be de minimis and the benefits to shareholders great. Also, there should be substantial collateral benefits, including: (1) the preemption of state takeover laws, (2) the elimination of the cumbersome appraisal process, (3) the inapplicability of the provisions of Internal Revenue Code dealing with golden parachutes and greenmail payments, and (4) the elimination of the need for applying liability rules to the change of control direc-

\textsuperscript{638} Corporate Governance Project, supra note 2.
tors. Since those directors would be conflict free and knowledgeable, it would indeed be the rare case when their actions would not be protected by the business judgment rule. Thus, there should be a substantial decrease in merger and acquisition litigation. In this connection, Professors Bebchuk and Ferrell have recently noted that "Delaware might purposely be maintaining a legal regime that encourages litigation. Delaware's corporate lawyers, an important interest group in Delaware, benefit from more, rather than less, litigation."

The change of control board will not deter tender offers, and, therefore, will not protect inefficient managers. The change of control board should facilitate the movement of corporate assets to their most productive uses and, therefore, should promote economic efficiency in the market for corporate control.

The only effective way to adopt the change of control board is through federal legislation, because it could not be expected that state legislatures would uniformly adopt this provision. Thus, there is a strong theoretical case for the adoption of a federal law mandating a change of control board, subject to the right of a corporation's independent shareholders to elect not to have the provision apply or to apply in limited circumstances.

Moreover, as reflected in the study by Professors Bradley and Schipani of the impact of section 102(b)(7) and in the studies surveyed by Professor Lin involving poison pills and other aspects of mergers and acquisitions, the current state of the empirical evidence supports the adoption of this proposal. If the relaxed liability exposure provided by section 102(b)(7) reduces shareholder welfare as found by Professors Bradley and Schipani, then the mandating of conflict-free and knowledgeable directors to deal with the merger and acquisition process should increase shareholder welfare.

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639 Bebchuk & Ferrell, supra note 3, at 1191 (footnote omitted).
640 See, e.g., Carney, Competition for Corporate Charters, supra note 472.
641 Bradley & Schipani, supra note 372.
642 Lin, supra note 438, at 930-37. See Part V.
APPENDIX

PROPOSED SECTION 14A
OF THE SECURITIES EXCHANGE ACT OF 1934

CHANGE OF CONTROL BOARD

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<td><strong>Section 14A</strong></td>
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<tr>
<td><em>(a) Affected Issuers.</em></td>
<td>Affected issuers are domestic publicly held corporations with respect to which a trigger event, as defined in Section 14A(b) below, has occurred. See Part III.B.</td>
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<td>Unless the public shareholders vote to elect-out under Section 14A(o), or pursuant to rules promulgated under Section 14A(p) the corporate issuer is exempted from the application of this section, this section applies upon the happening of a trigger event, as defined in Section 14A(b), with respect to any domestic corporate issuer that has more than $10 million in assets and underlying common stock (as defined in regulations) held by at least 500 persons. Such corporate issuers are referred to herein as &quot;public corporations,&quot; and public corporations with respect to which a trigger event has occurred are referred to herein as &quot;affected issuers.&quot;</td>
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<td><em>(b) Trigger Events.</em></td>
<td>Proposed Section 14A(b)(1) encompasses all forms of transactions proposed to the target's board, including proposals for arm's length transactions, for management buyouts and for freezeouts. See Part III.B.</td>
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<td>A trigger event shall occur if:</td>
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<tr>
<td><em>(1) Arm's Length Mergers, Management Buyouts and Freezeouts.</em> The board of directors of a public corporation receives a bona fide proposal (1) to engage in a merger, consolidation or mandatory share exchange, whether effected directly or by means of a subsidiary, or (b) to purchase substantially all of such corporation's assets, or (c) to give the board's endorsement to a tender offer for a controlling position in such corporation, or (d) to engage in any other transaction having a similar effect;</td>
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</table>
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### (2) Self Initiated Mergers and Acquisitions

The board of directors of a public corporation initiates negotiations designed to lead to the acquisition of the corporation in a merger or acquisition transaction;

### (3) Target of Tender Offer

A public corporation becomes the subject of an unsolicited bona fide tender offer under section 14(d) for a controlling interest in such corporation;

### (4) 13D Filed

A Schedule 13D is filed with respect to a public corporation and the purpose of the acquisition as reflected in Item 4 of Schedule 13D is or may be for the acquisition of a controlling interest in such corporation;

### (5) Reverse Acquisition, De facto Merger

In exchange for the equity securities or assets of another corporate issuer, a public corporation issues its underlying common stock (as defined in regulations) that upon issuance will amount to in excess of 50% of such corporation's outstanding voting common stock.

### (c) Petition for Appointment of Change of Control Official

1. **Petition by Board of Directors.** Upon the happening of a trigger event as described in Section 14A(b), the board of directors of the affected issuer shall promptly petition the Change of Control Official (as described in paragraph (d) below) for appointment of a change of control board.

2. **Petition by SEC or Shareholders.** If the board of directors of an affected issuer does not promptly file such petition after the happening of a trigger event, then the Securities and Exchange Commission, or any shareholder or group of shareholders of the affected issuer owning at least 5% of the underlying common stock of the issuer may file such a petition.

### Proposed Section 14A(b)(2)

Encompasses merger and acquisition transactions that are initiated by the target's board as occurred in Smith v. Van Gorkom. See Part III.B.

### Proposed Section 14A(b)(3)

Would not prevent an acquiror from making an unsolicited tender offer for a target, but as a result of the tender offer, a change of control board would be appointed for the target. See Part III.B.

### Pursuant to Section 13(d) of the 1934 Act

A Schedule 13D is required to be filed upon the acquisition of more than 5% of the stock of a public issuer. See Part III.B.

### Proposed Section 14A(b)(5)

Codifies one aspect of the de facto merger doctrine. Under this provision, Time, Inc. would have been required to appoint a change of control board for its initial proposed acquisition of Warner, because the Warner shareholders would have ended up owning 62% of the resulting company. See Part III.B.

### It is the responsibility of the target's board to seek the appointment of a change of control board upon the happening of a trigger event.

### Proposed Section 14A(c)(2)

Gives the SEC and shareholders power to have a change of control board appointed if the board of directors fails to promptly act upon the happening of a trigger event. See Part III.C.
(d) The Change of Control Official.

(1) Appointment. The Change of Control Official shall be appointed by the Securities and Exchange Commission, with the concurrence of a majority of the members of the Federal Reserve Board. The appointment shall be made on non-political grounds, and the appointee must not be identified with any particular change of control theory or ideology. The Securities and Exchange Commission may appoint multiple Change of Control Officials who shall have responsibility for various sections of the country.

(2) Duties. The duties and responsibilities of the Change of Control Official shall include:

(i) Preparation of lists of qualified persons who are willing to serve as members of a change of control board.

(ii) Preparation of lists of qualified attorneys, investment bankers and other professionals who are willing to serve as advisers to a change of control board;

(iii) Selection of members of a change of control board as provided in Section 14A(e) below;

(iv) Consultation with change of control boards regarding the hiring by such boards of professional advisers, such as lawyers and investment bankers, and the administrative activities of such boards;

(v) Monitoring and evaluating the performance of each change of control board and its members; and

(vi) The performance of other functions as specified in the rules and regulations under this section.

The procedure under Proposed Section 14A(d)(1) for appointing the Change of Control Official is similar to that for appointment of United States Trustees in bankruptcy cases. However, the requirement of concurrence from the Federal Reserve Board is new. See Part III.C.

The duties and responsibilities of the Change of Control Official under Proposed Section 14A(d)(2) are similar to the duties and responsibilities of the United States Trustee in bankruptcy cases. See Parts III.C. and III.D.2.
### (e) Selection of Change of Control Board.

Upon the receipt of a petition, the Change of Control Official shall promptly appoint a change of control board for the affected issuer. Such board shall consist of three persons unless in the sole judgment of the Change of Control Official it is appropriate under the circumstances to have more than three board members, but in no event shall more than five persons be appointed to a change of control board. In making the selection, the Change of Control Official shall make a determination that each board member is not, pursuant to regulations to be promulgated by the Securities and Exchange Commission, interested in the contemplated merger or acquisition. The Change of Control Official shall also give consideration to the member's experience in dealing with merger and acquisition transactions and where appropriate to the member's knowledge of the industry in which the affected issuer operates. The Change of Control Official may in appropriate circumstances appoint to the change of control board one member of the target's regular board who is otherwise qualified to serve. To insure protection under the business judgment rule set out in Section 14A(i)(4), the Change of Control Official should be satisfied that each member will make a proper inquiry, will act in good faith, and will make decisions that he or she rationally believes to be in the best interest of the corporation. The members of the change of control board shall continue in office until resigning or dissolution of the board under Section 14A(1).

The procedures in Section 14A(e) for selection of the members of the change of control board should minimize the risk of cronyism or political motivation in the selection process. See Part III.C.
**Responsible and Authority of Members of a Change of Control Board**

1. **Basic Responsibilities.** The change of control board will have responsibility, pursuant to a majority of vote, for making all decisions normally within the scope of the authority of the affected issuer's board of directors relating in any way to a potential or actual merger or acquisition transaction with respect to such issuer, including:
   - (1) deciding, pursuant to the authority contained in paragraph (i)(1) below, whether to consider, accept or reject a proposal to enter into a merger or acquisition transaction;
   - (ii) preparation of a proxy statement, information statement or other disclosure document for shareholders relating to any merger or acquisition transaction;
   - (iii) preparation of the affected issuer's response to a tender offer on Schedule 14D-9;
   - (iv) the making of severance payments conditioned on a change of control transaction (i.e., golden parachutes);
   - (v) the repurchase at a premium of the stock of the issuer from a potential acquirer (i.e., greenmail);
   - (vi) the implementation, pursuant to the authority contained in paragraph (i)(1), of defensive tactics, such as the issuance of poison pills, that may have the foreseeable effect of blocking an unsolicited tender offer;
   - (vii) entering into lock-up agreements, such as share option and share exchange agreements, and asset option agreements;
   - (viii) the payment of hello fees or goodbye (i.e., termination) fees; and
   - (ix) any other matters relating to a merger or acquisition transaction.

2. **Hiring of Professionals.** With the consent of the Change of Control Official, the change of control board may hire its own independent attorney, investment banker and any other professionals as required by the circumstances.

3. **Authority.** The change of control board shall have the same authority to act as the issuer's normal board consistently with the governing state law, the charter documents, and the by-laws of the affected issuer. Thus, a change of control board may, provided the applicable state law and charter documents permit, issue a poison pill, subject only to the business judgment rule set out in Section 14A(i).

4. **Cooperation of Regular Board.** The board of directors of the affected issuer and all officers and other employees of the affected issuer shall cooperate fully with the change of control board. In the event a court, upon petition by the change of control board, determines that the board of directors is not cooperating fully, the court shall have the authority to suspend the board and replace it with the change of control board.

Proposed Section 14A(e)(1) gives the change of control board complete control over all matters bearing on a change of control transaction. There would be no reason for a change of control board to issue a deadhand pill, and any deal protection devices adopted by the change of control board would be subject to the business judgment rule, thus eliminating the source of many disputes arising under the current system. See Part III.D.

It is crucial that the change of control board have the authority to retain its own independent professionals. See Part III.D.

Proposed Section 14A only empowers the change of control board to take those actions that could otherwise be taken by the target's normal board of directors. See Part III.D.

This type of provision is needed to force the target's board to cooperate. See Part III.D.
### (g) Compensation of Members of Change of Control Board.

The members of the change of control board shall be compensated by the affected issuer on a fee for services basis pursuant to rules and a periodically updated fee schedule promulgated by the Securities and Exchange Commission. In promulgating such rules, the Securities and Exchange Commission shall take into consideration such factors as the size of the parties, the complexity of the transaction and the level of fees that would be payable in the open market for comparable work for comparable companies. The members shall also be reimbursed for their reasonable expenses, pursuant to rules promulgated by the Securities and Exchange Commission.

This type of compensation arrangement should be both fair and acceptable to most potential members of a change of control board. See Part III.D.2.

### (h) Compensation of Professional Advisers.

1. **Fee for Services.** The professional advisers to the change of control board will be compensated by the affected issuer on a fee for services basis pursuant to rules and a periodically updated fee schedule promulgated by the Securities and Exchange Commission. Professional advisers shall also be reimbursed for their reasonable expenses, pursuant to rules promulgated by the Securities and Exchange Commission.

2. **Contingent Compensation.** In appropriate cases pursuant to rules promulgated by the Securities and Exchange Commission and with the approval of the Change of Control Official, contingent fees may be paid to investment bankers that are responsible for adding significant value to the transaction for the affected issuer's stockholders.

This type of fee for services compensation arrangement might be objectionable to some investment bankers, but in appropriate cases, contingent fees could be paid under Section 14A(h)(2). See Part III.D.
(1) **Scope of Authority, Duty of Care and the Business Judgment Rule.**

(1) **Scope of Authority.** The change of control board, in the exercise of its business judgment, may approve, reject or decline to consider a proposal to the affected issuer to engage in a merger or acquisition transaction and may take an action that has the foreseeable effect of blocking an unsolicited tender offer.

(2) **Other Constituencies.** In the exercise of its business judgment, the change of control board may have regard for interests or groups (other than shareholders) with respect to which the affected issuer has a legitimate concern if to do so would not significantly disfavor the long-term interest of shareholders.

(3) **Duty of Care.** In exercising his or her business judgment, each member of the change of control board has a duty to the affected issuer to perform his or her functions in good faith, in a manner he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances. The duty set forth above includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the director reasonably believes to be necessary. In performing his or her functions, a director is entitled to rely on materials and persons in accordance with the principles in Sections 4.02 and 4.03 of the ALI Corporate Governance Project.

(4) **Business Judgment Rule.** A member of a change of control board who makes a business judgment in good faith fulfills his or her duty under this section if: (a) he or she is not interested in the subject of the business judgment; (b) he or she is informed with respect to the subject of his or her business judgment to the extent he or she reasonably believes to be appropriate under the circumstances, and (c) he or she rationally believes that his or her business judgment was in the best interest of the corporation.

(5) **Burden of Proof.** A person challenging the conduct of a member of the change of control board has the burden of proving by clear and convincing evidence that there has been a breach of the duty of care including the inapplicability of the business judgment rule as set forth in paragraph (4) above, and such person has the burden of proving that the breach was the legal cause of damage suffered by the corporation.

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Section 14A(i)(1) adopts the standard set out in Sections 6.01(a) and 6.02(a) of the ALI Corporate Governance Project. See Part III.E.

Section 14A(i)(2) adopts the view of Section 6.02(b)(1) of the ALI Corporate Governance Project regarding other constituencies. See Part III.E.

Section 14A(i)(3) sets out the duty of care rule contained in Section 4.01(a) of the ALI Corporate Governance Project. See Part III.E.

Proposed Section 14A(i)(4) adopts the business judgment rule as set forth in Section 4.01(c) of the ALI Corporate Governance Project. See Part III.E. The board's decision would be protected by the business judgment rule as long as a majority of the members approving the action is protected.

Section 14A(i)(5) adopts the burden of proof provision of Section 4.01(d) of the ALI Corporate Governance Project, except a clear and convincing standard of proof rule applies for establishing that the business judgment rule is not available. See Part III.E.
(j) No Personal Liability, Insurance and Indemnification.

1. No Personal Liability. Absent proof by clear and convincing evidence that a member of a change of control board acted with an intent to defraud, no member of a change of control board shall have any personal liability for actions taken or not taken as a member of a change of control board.

2. Insurance and Indemnification. Upon the appointment of the change of control board the affected issuer shall, pursuant to rules promulgated by the Securities and Exchange Commission, promptly provide indemnification and insurance for the members of the change of control board. Such insurance and indemnification is to cover all actions taken in connection with the member's activities on the change of control board, except any actions amounting to fraud.

(k) Arbitration in Majority Control Freezeouts.

If a controlling shareholder controls sufficient votes of the controlled corporation to unilaterally effectuate the acquisition by merger, sale of assets or otherwise, of all of the controlled corporation's stock or of substantially all of its assets, and the controlling shareholder and the change of control board for the controlled corporation do not, within the time period specified in rules promulgated by the Securities and Exchange Commission, reach a decision on the price and other terms for such transaction, then the price and other terms shall be determined pursuant to a binding arbitration proceeding in accordance with rules promulgated by the Securities and Exchange Commission.

(l) Dissolution of Change of Control Board.

Once the affected issuer is no longer the subject of a proposed merger or acquisition, the change of control board shall petition the Change of Control Official to have the change of control board dissolved. If the change of control board does not, within a reasonable period, file such a petition, then such a petition may be filed by either the Securities and Exchange Commission or a shareholder or shareholders of the affected issuer owning at least 5% of the issuer's outstanding common stock.

It is crucial that the members of the change of control board be protected from personal liability, except in the case of fraud. See Part III.F.

Proposed Section 14A(k) is designed to eliminate a deadlock between the change of control board for a controlled sub and the controlling parent in a freezeout transaction in which the controlling parent has sufficient votes to unilaterally complete the transaction. See Part III.G.

Once the change of control transaction is either abandoned or effectuated, there is no longer a need for a change of control board. See Part III.H.
(m) Federal Jurisdiction and Preemption of State Law.

(1) Federal Jurisdiction. Any suits brought under this provision shall be brought in the appropriate federal district court, which generally shall be the district court for the district in which the affected issuer has its headquarters. Such district court shall have exclusive jurisdiction over the matter.

(2) Preemption of State Law. The provision shall preempt all state statutes bearing on change of control transactions, including all state appraisal statutes. This preemption shall not apply to those provisions setting out normal shareholder voting procedures for change of control transactions. Thus, this provision preempts such items as control share statutes, business combination statutes, disgorgement requirements and other constituency statutes. The Securities and Exchange Commission shall promulgate regulations specifying those state statutes that are preempted.

(3) Preemption of Charter Documents. This provision shall preempt all charter documents, by-laws and other contractual arrangements of an affected issuer bearing on merger and acquisition transactions, other than those provisions setting out normal shareholder voting procedures for such transactions. Thus, this provision preempts all golden parachute contracts, poison pills, fair price provisions and shark repellant provisions entered into by the corporation's regular board. The securities and Exchange Commission shall promulgate rules specifying those types of corporate provisions and contracts that are preempted.

(n) Transition Rules.

(1) Delayed Effective Date. This provision shall be effective three months after the date of enactment.

(2) Voiding Contracts. Upon the effective date of this provision all executory contacts of the corporation relating to matters within the jurisdiction of the change of control board, such as golden parachute contracts, poison pills, fair price provisions and shark repellant provisions shall be null and void.

Proposed Section 14A(m)(1) makes it clear that there is exclusive federal jurisdiction over the change of control board. See Part III.I.

Proposed Section 14A(m)(2) makes it clear that this provision preempts all state appraisal statutes and all non-normal state statutes bearing on change of control transactions. See Part III.I.

Proposed Section 14A(m)(3) clarifies that this provision preempts all non-normal corporate and contract provisions bearing on mergers and acquisitions. This ensures that the change of control board has plenary authority over such matters. See Part III.I.

Consideration could be given to grandfathering certain provisions for a limited period. See Part III.K.
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<th>(o) <strong>Election Out.</strong></th>
<th>This provision permits the public shareholders, on their own initiative and without the influence of management or a controlling shareholder, to elect to have this provision or specified subsections of this provision not apply to the corporation. Thus, for example, the public shareholders could elect to have the provision apply only to hostile tender offers. Also, even after a change of control board is appointed, a target's shareholders may, pursuant to regulations promulgated by the SEC, elect to remove the change of control board. See Part III.N.</th>
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<tr>
<td>The public shareholders of a corporation otherwise subject to this provision, which shareholders are in no way related to or controlled by the management of the corporation or a controlling shareholder, may, pursuant to rules and regulations promulgated by the Securities and Exchange Commission, elect not to have this provision or specified subsections of this provision apply to the corporation.</td>
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<td>(p) <strong>Exemption Pursuant to Rule.</strong></td>
<td>This provision permits the SEC to exempt certain domestic corporate issuers from the application of this section where it appears that because of the structure of the ownership of such corporation or the fact that the corporation has just recently become a public corporation or any similar reason, it would be inappropriate to apply the change of control board concept to such corporation.</td>
</tr>
<tr>
<td>The Securities and Exchange Commission may promulgate rules and regulations exempting certain corporate issuers from the application of this section where it appears that because of the structure of the ownership of such corporation or the fact that the corporation has just recently become a public corporation or any similar reason, it would be inappropriate to apply the change of control board concept to such corporation.</td>
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<td>(q) <strong>Illegality.</strong></td>
<td>This provision is designed to prevent parties from attempting to trigger a change of control board for strategic purposes.</td>
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<td>It shall constitute a violation of the Act for any person or persons to make a non-bona fide tender offer or a non-bona fide merger or acquisition proposal to a public corporation for the purpose of causing a trigger event to occur and a change of control board to be appointed.</td>
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