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Enhanced Scrutiny on the Buy-Side

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ENHANCED SCRUTINY ON THE BUY-SIDE

Afra Afsharipour * and J. Travis Laster***

Empirical studies of acquisitions consistently find that public company bidders often overpay for targets, imposing significant losses on bidder shareholders. Numerous studies have connected bidder overpayment with managerial agency costs and behavioral biases that reflect management self-interest. For purposes of corporate law, these concerns implicate the behavior of fiduciaries—the officers and directors of the acquiring entity—and raise questions about whether those fiduciaries are fulfilling their duty of loyalty. To address comparable sell-side concerns, the Delaware courts developed an intermediate standard of review known as enhanced scrutiny. There has been little exploration, however, of whether the rationales for applying enhanced scrutiny to the actions of sell-side fiduciaries extend to comparable fiduciaries on the buy-side.

This Article addresses this long-neglected question. Drawing upon the history of Delaware jurisprudence on enhanced scrutiny, it argues that enhanced scrutiny should extend to the decisions of buy-side fiduciaries. The Article also recognizes that, although doctrinally coherent, applying enhanced scrutiny to buy-side decisions would open the door to well-documented stockholder litigation pathologies that have undermined the effectiveness of enhanced scrutiny for sell-side decisions. To address these pathologies, the Delaware

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courts have recently encouraged the use of fully informed stockholder votes on the sell-side to lessen litigation risk. This Article reasons that a primary argument in favor of extending enhanced scrutiny to buy-side decisions rests not on the ability of the litigation itself to generate superior outcomes, but rather as an inducement to more frequent buy-side votes. This argument builds on recent empirical literature which finds that stockholder voting can provide an important counterbalance against the self-interest and biases that lead to bidder overpayment.

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I. INTRODUCTION

Empirical studies of acquisitions consistently find that public company bidders often overpay for targets, imposing significant losses on bidder shareholders.[1] Research also indicates that the losses represent true wealth destruction in the aggregate and not simply a wealth transfer from bidder shareholders to target shareholders.[2] Numerous studies have connected bidder overpayment with managerial agency costs[3] and behavioral biases that reflect management self-interest.[4] For purposes of corporate law, these concerns implicate the behavior of fiduciaries—the officers and directors of the acquiring entity—and raise questions about whether those fiduciaries are fulfilling their duty of loyalty.

Beginning in the 1980s, to address circumstances that present a high risk of self-interest, the Delaware courts began to develop an

[1] *See* Afra Afsharipour, *Reevaluating Shareholder Voting Rights in M&A Transactions*, 70 OKLA. L. REV. 127, 133–34 (2017) (surveying research regarding bidder overpayment) [hereinafter Afsharipour, *Voting Rights*]; Afra Afsharipour, *A Shareholders' Put Option: Counteracting the Acquirer Overpayment Problem*, 96 MINN. L. REV. 1018, 1032–34 (2012) (same) [hereinafter Afsharipour, *Put Option*].

[2] Sara B. Moeller et al., *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*, 60 J. FIN. 757, 757–59 (2005) [hereinafter Moeller et al., *Wealth Destruction*].

[3] *See, e.g.*, Leonce Bargeron et al., *Why Do Private Acquirers Pay So Little Compared to Public Acquirers?*, 89 J. FIN. ECON. 375, 376 (2008); *infra* notes 34–42 and accompanying text. For more on "empire building," see Christopher Avery et al., *Why Do Managers Undertake Acquisitions? An Analysis of Internal and External Rewards for Acquisitiveness*, 14 J.L. ECON. & ORG. 24, 24–28, 42 (1998); Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 627–28 (1989); John C. 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, 1167–69, 1224–29, 1269–80 (1984) [hereinafter Coffee, *Regulating*]; John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 29 (1986).

[4] *See* Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197, 212 (1986) (finding that manager hubris may explain takeovers without gain); *see also* RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE 50–62 (1992) (providing data highlighting suboptimal bidder behavior due to "the winner's curse"); Black, *supra* note 3, at 601–05, 624 ("Some managers, surely, are habitually optimistic and therefore likely to overestimate a target's value"); Mark L. Sirower & Mark Golovcsenko, *Returns from the Merger Boom*, MERGERS & ACQUISITIONS: DEALMAKER'S J., Mar. 1, 2004, at 34, 2004 WLNR 18181954 (finding that the "subsequent performance of the persistent performers is largely a function of acquirers confirming . . . the initial perceptions of investors"); Richard H. Thaler, *Anomalies: The Winner's Curse*, 2 J. ECON. PERSP. 191, 193–201 (1988) (presenting evidence "suggesting that the winner's curse may be a common phenomenon").

intermediate standard of review known as enhanced scrutiny.[5] The situations evaluated in these cases did not encompass the flagrant self-dealing often observed in traditional duty of loyalty cases, but instead involved the potential risk of soft conflicts and fiduciary self-interest.[6] Much of Delaware's enhanced scrutiny jurisprudence was developed through scrutiny of decisions by sell-side fiduciaries.[7] We argue that the enhanced scrutiny framework has become a means of screening for improperly motivated actions "when the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors."[8]

Because the core conflict-derived rationale that supports applying enhanced scrutiny to actions by sell-side fiduciaries applies equally on the buy-side, we propose extending enhanced scrutiny to the decisions of buy-side fiduciaries.[9] The decision to undertake a significant acquisition differs from other routine business judgments taken by directors and officers. As in the sell-side scenario, acquisitions are often large transactions that are plagued by subtle personal interests that affect the decision-making process.[10] Empirical evidence suggests that in acquisitions, particularly significant acquisitions, the business judgment of boards is contaminated by the interests of managers and advisors

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[5] *See infra* Part III.A.

[6] In many jurisdictions, corporate law may limit board discretion if the transaction creates a possible conflict of interest for fiduciaries, "even if th[e] conflict does not qualify as a related-party transaction." Edward Rock et al., *Fundamental Changes, in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 173 (3d ed. 2017). With respect to fundamental transactions, such as mergers and acquisitions, "[l]ow-powered conflicts of interest frequently dog major transactions, even without signs of flagrant self-dealing." *Id*.

[7] *See generally* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); J. Travis Laster, Revlon *Is a Standard of Review: Why It's True and What It Means*, 19 FORDHAM J. CORP. & FIN. L. 5 (2013).

[8] Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 457 (Del. Ch. 2011). *See* discussion *infra* Part III.A.

[9] Generally, Delaware courts have reviewed a board's decision to acquire another company under the deferential business judgment standard; therefore, the body of case law addressing the fiduciary duties of buy-side boards is scant. For a discussion, see generally Afsharipour, *Put Option*, *supra* note 1, at 1055–1061 (summarizing literature).

[10] While not all mergers and acquisitions are fundamental or large transactions, many "exhibit the functional characteristics of fundamental changes: they are large; they often give rise to agency problems; and they involve investment-like decisions." Rock et al., *supra* note 6, at 184 (citation omitted).

on whom boards of directors rely.[11] The board's judgment is even more contaminated in public company acquisitions where the potential for realization of the value of the transaction is uncertain, but the prestige and compensation connected with purchasing another public company is high.[12]

Although doctrinally coherent, applying enhanced scrutiny to buy-side decisions would open the door to well-documented stockholder litigation pathologies that have undermined the effectiveness of the sell-side regime.[13] In recent years, the Delaware courts have strived to lessen the impact of these pathologies. One powerful intervention has been to lower the standard of review from enhanced scrutiny to the business judgment rule if the transaction receives fully informed stockholder approval.[14] Logically, this innovation also would apply to bidder fiduciaries.

It seems likely, therefore, that a principal consequence of applying enhanced scrutiny to bidder decisions would be to induce more buy-side stockholder votes.[15] There are substantial reasons to believe that buy-side stockholder votes would be an effective tool to limit the bidder overpayment phenomenon.[16] On balance, extending enhanced scrutiny to decisions by buy-side fiduciaries should lead to a superior regime in which stockholders can provide a meaningful check on bidder overpayment.[17]

This Article proceeds as follows. Part II summarizes the bidder overpayment problem and the empirical explanations for overpayment: agency costs and behavioral biases. The explanations for overpayment highlight soft conflicts of interests and implicate

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[11] *See infra* Part II.B.

[12] *See infra* Part II. A–B.

[13] *See infra* notes 166-172 and accompanying text.

[14] *See* Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 309 (Del. 2015) ("[W]hen a transaction not subject to the entire fairness standard is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies.").

[15] *See* Afsharipour, *Voting Rights, supra* note 1, at 139–142 (describing common acquisition structures, and how bidders can avoid stockholder voting rights by using cash or a combination of cash and stock where the stock component constitutes less than 20% of issued and outstanding bidder shares).

[16] *See id.* at 147–55 (addressing empirical research and arguing that the rise of institutional investors and proxy advisory firms, coupled with the monitoring function of voting shareholders, may effectively limit bidder overpayment).

[17] *See id.* (concluding that arguments against bidder shareholder voting due to cost and uncertainty are "overstated" and arguing for shareholder voting rights "in situations of high importance to firm value and share price").

the role of fiduciaries. Delaware law has developed a nuanced framework—enhanced scrutiny—for reviewing the decisions of sell-side fiduciaries. In Part III we examine the development of enhanced scrutiny in order to determine whether enhanced scrutiny may be used to address bidder overpayment.

Part IV argues that the Delaware courts' rationales for applying enhanced scrutiny to the decisions of target boards in third-party M&A transactions equally hold in the context of bidder boards. This part then assesses both supporting and countervailing considerations for using litigation as the solution to the fiduciary conflicts that lead to problems on the bidder side. Over the past several years the Delaware courts have encouraged the use of a fully informed stockholder vote on the sell-side to lessen litigation risk in third-party M&A transactions.

In Part V, we reason that the primary argument for extending enhanced scrutiny to buy-side decisions is not that the litigation itself will generate superior outcomes, but rather that buy-side companies will have a greater incentive to undertake shareholder votes on a proposed transaction. This argument builds on recent empirical literature which finds that voting by stockholders can provide an important counterbalance to guard against the self-interest and biases that lead to bidder overpayment.

II. Bidder Overpayment and Its Causes

Hewlett-Packard (HP), a Silicon Valley icon, agreed to acquire UK software firm Autonomy for approximately $11 billion in August 2011.[18] The deal was a boon for Autonomy shareholders, who received a premium of almost 64 percent to Autonomy's share price at the time of announcement.[19] By November 2012, HP announced a write-down of $8.8 billion related to the Autonomy acquisition, including a write down of $5 billion related to accounting problems

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[18] *See* James B. Stewart, *From H.P., a Blunder That Seems to Beat All*, N.Y. TIMES (Nov. 30, 2012), http://www.nytimes.com/2012/12/01/business/hps-autonomy-blunder-might-be-one-for-the-record-books.html.

[19] *See* Michael J. de la Merced & Jeffrey Cane, *Hewlett-Packard Strikes $11.7 Billion Deal; Plans to Spin Off P.C. Unit*, N.Y. TIMES (Aug. 18, 2011, 12:33 PM), https://dealbook.nytimes.com/2011/08/18/hewlett-packard-said-to-be-near-10-billion-deal-and-p-c-spinoff/.

at Autonomy.[20] The disastrous deal destroyed billions of dollars in value for HP shareholders, and resulted in large securities class-action suits against HP.[21] While the extent of the loss suffered by HP was a surprise, analysts had warned at the outset that the Autonomy deal was "wildly overpriced."[22] According to reports, HP's zealous courtship of Autonomy was spearheaded by Léo Apotheker, HP's then-new chief executive officer, who was eager to use the Autonomy acquisition to make his mark at the company.[23] The failed Autonomy deal was only one in a string of poorly performing acquisitions—all of which were touted by a series of successive HP CEOs as acquisitions that would "transform" the company.[24]

A. BIDDER OVERPAYMENT

HP's acquisition of Autonomy illustrates a striking pattern in public company acquisitions. A vast body of empirical literature has shown "that a large percentage of transactions involve negative returns for acquirer shareholders . . . and that the losses from the worst performing deals are very large."[25] A comprehensive review of

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[20] *See* Stewart, *supra* note 18.

[21] *See* Richard Waters & Peter Campbell, *HP Enterprise Seeks to End Autonomy Saga with Software Sale*, FIN. TIMES (Sept. 2, 2016), https://www.ft.com/content/e657857a-7113-11e6-a0c9-1365ce54b926; Juliette Garside, *HP to Pay $100m to Settle Autonomy Dispute*, THE GUARDIAN (June 9, 2015, 2:02 EDT), https://www.theguardian.com/business/2015/jun/09/hp-autonomy-settle-lawsuit (reporting that HP would pay $100 million to settle a shareholder lawsuit relating to the purchase of Autonomy).

[22] Stewart, *supra* note 18.

[23] *See* James B. Stewart, *Léo Apotheker May Have Been Worse H.P. Chief Than Carly Fiorina*, N.Y. TIMES (Oct. 8, 2015), https://www.nytimes.com/2015/10/09/business/leo-apotheker-may-have-been-worse-hp-chief-than-carly-fiorina.html (describing Apotheker's lack of due diligence and assurances to board members who questioned the deal); Clive Longbottom, *HP: Where Next for the Troubled Silicon Valley Giant*, COMPUTERWEEKLY.COM, http://computerweekly.com/feature/HP-Where-next-for-the-troubled-Silicon-Valley-giant (stating that Apotheker "tried to make his mark on the firm through acquisition," with Autonomy as the largest of his deals).

[24] *See* Longbottom, *supra* note 23 (listing poorly performing acquisitions by other HP CEOs, including Carly Fiorina's acquisition of Compaq and Mark Hurd's acquisitions of Peregrine Systems and Mercury Interactive); James Bandler & Doris Burke, *How Hewlett-Packard Lost Its Way*, FORTUNE (May 8, 2012), http://fortune.com/2012/05/08/how-hewlett-packard-lost-its-way (describing Apotheker's purchase of Autonomy as an effort to "transform[]" HP into a software company and describing previous CEO Mark Hurd's acquisition of Palm Inc. as a major "attempt[] to fashion a growth strategy" which ultimately did not pan out).

[25] Marco Becht et al., *Does Mandatory Shareholder Voting Prevent Bad Acquisitions?*, 29 REV. FIN. STUDIES 3035, 3036 (2016) (citations omitted). For a summary of the research on

the empirical literature concluded that historically, "acquisitions did not enhance acquiring firm value, as measured by either short-term . . . or long-term performance measures."[26]

The bidder overpayment problem varies by type of bidder and the bidding scenario. Bidder overpayment tends to be particularly acute when public-company bidders acquire public-company targets.[27]

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the "bidder overpayment problem," see generally Afsharipour, *Voting Rights*, *supra* note 1, at 132–34 and Afsharipour, *Put Option*, *supra* note 1, at 1032–34. Many empirical researchers have found that some acquisitions generate negative returns. *See* Gregor Andrade et al., *New Evidence and Perspectives on Mergers*, 15 J. ECON. PERSP. 103, 110–11 (2001); Christa H. S. Bouwman et al., *Market Valuation and Acquisition Quality: Empirical Evidence*, 22 REV. FIN. STUDIES 633, 636 (2009); Jarrad Harford et al., *The Sources of Value Destruction in Acquisitions by Entrenched Managers*, 106 J. FIN. ECON. 247, 247–48, 260 (2012); Tim Loughran & Anand M. Vijh, *Do Long-Term Shareholders Benefit from Corporate Acquisitions?*, 52 J. FIN. 1765, 1773–89 (1997); Sara B. Moeller et al., *Firm Size and the Gains from Acquisitions*, 73 J. FIN. ECON. 201, 202, 226 (2004); Moeller et al., *Wealth Destruction*, *supra* note 2, at 781; Gunther Tichy, *What Do We Know About Success and Failure of Mergers?*, 1 J. INDUSTRY COMPETITION & TRADE 347, 366–68 (2001). There is some evidence that acquisition activity funded with overvalued bidder stock may benefit bidder stockholders in the long run so long as the target firm's stock is relatively less overvalued. *See* Andrei Shleifer & Robert W. Vishny, *Stock Market Driven Acquisitions*, 70 J. FIN. ECON. 295, 301 (2003). Another study finds that "overvalued acquirers often significantly overpay for the targets they purchase" and that such "acquisitions do not produce the necessary synergy gains." Fangjian Fu et al., *Acquisitions Driven by Stock Overvaluation: Are They Good Deals?*, 109 J. FIN. ECON. 24, 25 (2013). The authors report that "[o]vervalued acquirers incur significantly worse stock returns during the five years following acquisitions than the control firms that did not engage in mergers" and experience "significant deterioration in operating performance." *Id.* at 26.

[26] Jerayr Haleblian et al., *Taking Stock of What We Know About Mergers and Acquisitions: A Review and Research Agenda*, 35 J. MGMT. 469, 470 (2009) (citations omitted). Post-acquisition, CEOs tend to exercise options and sell their stock in the acquirer, indicating that "they do not appear to anticipate long-term value creation from their acquisitions." Cynthia E. Devers et al., *Do They Walk the Talk? Gauging Acquiring CEO and Director Confidence in the Value Creation Potential of Announced Acquisitions*, 56 ACAD. MGMT. J. 1679, 1679 (2013). The verdict on bidder overpayment, however, is not unanimous. Some scholars have argued that "the early papers which found that shareholders of acquirers earned zero or mostly negative abnormal returns in the post-1980s period have to be reexamined" due to estimation issues. *See* Darius Palia, *The Market for Corporate Control: Survey of the Empirical Evidence, Estimation Issues, and Potential Areas for Future Research*, in RESEARCH HANDBOOK ON MERGERS AND ACQUISITIONS (Claire A. Hill & Steven Davidoff Solomon, eds. 2016); *see also* Mark Humphery-Jenner, Ronald W. Masulis, & Peter L. Swan, *Do Wealth Creating Mergers and Acquisitions Really Hurt Bidder Shareholders?* 7 (FIRN Research Paper 2517209, Feb. 14, 2017), https://ssrn.com/abstract=2517209 (arguing that "traditional event study methodology fails to account for the negative information that takeover bids often release, thereby downward biasing returns calculated using a standard event study methodology").

[27] *See* Sandra Betton et al., *Corporate Takeovers*, *in* 2 HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 291, 407 (B. Espen Eckbo ed., 2008) (showing that offer premiums are greater for public bidders); *accord* Moeller et al., *Wealth Destruction*, *supra* note 2, at 770–71 ("[A]cquisitions of public firms . . . lead to lower acquiring-firm abnormal

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Private acquirers tend to pay less in acquisitions than public bidders, and private companies that make acquisitions tend to outperform their public peers.[28] There is evidence that certain serial acquirers, such as Cisco and Berkshire Hathaway, tend to make good acquisitions, and that an acquirer's penchant for making good or bad acquisitions persists across deals.[29]

More recently, one study questioned whether the bidder overpayment trend holds for more recent acquisitions. The study, which compared M&A transactions from 2009-2015 to M&A transactions from 1990-2009, suggests that post-2009 M&A deals created positive and significant returns for acquiring firm shareholders.[30] The authors of the study posit that the evidence of less overpayment post the 2008 financial crisis is linked to "improvements in the quality of corporate governance among acquiring firms."[31]

It is unclear whether these positive bidder returns will continue. Some studies indicate that deals done during a weak economy, such as during the recession that followed the 2008 financial crisis, perform better than deals undertaken during a strong economy.[32] One argument for why strong economy deals perform more poorly is that when the economy is strong, managers with less discipline—

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returns."); *see also* Asli M. Arikan & René M. Stulz, *Corporate Acquisitions, Diversification, and the Firm's Life Cycle*, 71 J. FIN. 139, 139 (2016) (finding that stock price reaction to acquisitions of public firms by older firms is negative). There is considerable debate in the literature about whether cash or stock deals are better for bidder shareholders. *See* Haleblian et al., *supra* note 26, at 479. One study concludes, however, that the "worst-case scenario" for bidder stockholders is an all-stock acquisition of another public company. Betton et al., *supra*, at 413.

[28] *See* Andrey Golubov & Nan Xiong, *Why Do Private Acquirers Outperform Public Acquirers?* 2 (European Corp. Governance Inst. Working Paper Series in Fin., Paper No. 482/2016, Sept. 2016), https://ssrn.com/abstract=2834805 (reviewing 6,386 acquisitions from 1997-2010 and finding that private acquirers outperform public company acquirers in both return on assets and in asset utilization for one, two and three years following the acquisition); Bargeron et al., *supra* note 3, at 376 (finding that private firms pay lower premiums relative to public bidders without high managerial ownership).

[29] *See* Andrey Golubov et al., *Extraordinary Acquirers*, 116 J. FIN. ECON. 314, 315 (2015).

[30] G. Alexandridis, N. Antypas, N. Travlos, *Value Creation from M&As: New Evidence*, 45 J. CORP. FIN. 632, 633 (2017).

[31] *Id.* at 632.

[32] *See, e.g.*, Jens Kengelbach et al., *As Prices Peak, Should Dealmakers Wait for the Next Downturn*, BOS. CONSULTING GRP. (Mar. 16, 2018), http://image-src.bcg.com/Images/BCG-As-Prices-Peak-Should-Dealmakers-Wait-for-the-Next-Downturn-Mar-2018_tcm9-186956.pdf (analyzing "global transactions of more than $250 million from 1985 through 2014" and finding that "weak-economy deals performed better than strong-economy deals").

or more self-interest—have the capability to pursue value reducing acquisitions with little market oversight.[33] Thus, it may be that deals done post-2015, a period during which the economy has been quite strong, will prove to have destroyed value for acquirer shareholders.

B. THE CAUSES OF OVERPAYMENT

One contributor to bidder overpayment is managerial agency costs. Agency theorists in law, management, and finance argue that agency costs explain bidder overpayment—that is management pursues wealth-destroying acquisitions at the expense of shareholders.[34] Numerous studies provide evidence that acquisitions offer significant benefits to bidder management—particularly bidder CEOs—in the form of increased compensation, power, and prestige.[35] For example, studies find that acquisitions

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[33] Acquisitions are capital intensive transactions, and firms frequently finance a large portion of the transaction; thus, access to credit markets, which is much more available during a strong economy, is an important component in a firm's ability to undertake an acquisition. *See* George Alexandridis et al., *Financial Hedging and Corporate Investment: Evidence from Mergers and Acquisitions,* EFMA 2017 Annual Conference (June 19, 2017), http://www.efmaefm.org/0EFMAMEETINGS/EFMA%20ANNUAL%20MEETINGS/2017-Athens/papers/EFMA2017_0497_fullpaper.pdf.

[34] *See, e.g.*, Black, *supra* note 3, at 627–28 (discussing principal-agent conflicts in takeovers); Coffee, *Regulating*, *supra* note 3, at 1167–69, 1224–29; Ronald W. Masulis et al., *Corporate Governance and Acquirer Returns*, 62 J. FIN. 1851, 1852 (2007).

[35] *See, e.g.,* Soojin Yim, *The Acquisitiveness of Youth: CEO Age and Acquisition Behavior*, 108 J. FIN. ECON. 250, 271 (2013) (finding that acquisitions "are associated with large, permanent increases in CEO compensation"); Fu et al., *supra* note 25, at 4 (finding that "acquirer CEOs in overvaluation-driven acquisitions obtain substantial pecuniary benefits following these transactions, specifically large new restricted stock and option grants" and that these benefits outweigh any losses suffered from a decline in value of the CEO's stock holdings); Haleblian et al., *supra* note 26, at 475 (positing that CEO compensation is a significant factor contributing to acquisitions and overpayment because "managing larger firms generally also increases CEO discretion and power, which can further entrench managers and reduce their employment risk" (citation omitted)); Jarrad Harford & Kai Li, *Decoupling CEO Wealth and Firm Performance: The Case of Acquiring CEOs*, 62 J. FIN. 917, 918 (2007) (finding that acquiring firm CEOs are financially rewarded for acquisitions, but are not similarly rewarded for other types of major capital expenditures; positing that "by increasing the size of the firm and changing its scope of operations, acquisitions provide a natural opportunity for the CEO and the board to restructure his compensation," increasing the ability of the CEO to advocate "for more pay and for pay that is less sensitive to performance for the first few years of the acquisition"); Yaniv Grinstein & Paul Hribar, *CEO Compensation and Incentives: Evidence from M&A Bonuses*, 73 J. FIN. ECON. 119, 121 (2004) (showing that CEOs who have more power to influence board decisions receive significantly larger M&A bonuses, but these bonuses are not related to deal performance); Adam Steinbach

"are associated with large, permanent increases in CEO compensation."[36] Studies also find that CEOs are financially rewarded for acquisitions in the form of large, new options and grants, but are not similarly rewarded for other types of major transactions.[37]

Other studies provide indirect support for a managerial agency cost explanation. Using takeover defenses as a proxy for managerial entrenchment, researchers have shown that acquirers with more takeover defenses generate lower returns from their acquisitions than acquirers with fewer anti-takeover devices.[38] One study found that bidders with weak governance structures tend to overpay significantly and fail to achieve anticipated synergy gains.[39] Another study found that entrenched managers disproportionately avoid private-company targets,[40] even though bidder performance in private-company acquisitions is significantly better than public company targets,[41] arguably because the lesser prestige of a private

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et al., Peering into the Executive Mind: Expanding Our Understanding of the Motives for Acquisitions, in 15 ADVANCES IN MERGERS AND ACQUISITIONS 73 (2016) (discussing studies finding that "CEOs who are underpaid relative to peer CEOs engage in higher levels of acquisition activity than other CEOs, perhaps, as a means of increasing their own compensation to better align with peers' pay"); Jarrad Harford, *Corporate Cash Reserves and Acquisitions,* 54 J. FIN. 1969, 1969 (1999) (finding that "cash-rich firms are more likely than other firms to attempt acquisitions" and their acquisitions are more likely to be value-decreasing); *see also* Richard T. Bliss & Richard J. Rosen, *CEO Compensation and Bank Mergers*, 61 J. FIN. ECON. 107, 108 (2001) (finding that CEO compensation in bank mergers increases even if the merger causes the acquirer's stock price to decline). *But see* Arikan & Stulz, *supra* note 27, at 190 (finding "no support for the prediction of agency theories that mature firms with high cash holdings but poor growth opportunities acquire more").

[36] Yim, *supra* note 35, at 271.

[37] *See* Harford & Li, *supra* note 35, at 919 (finding that "[CEO] compensation changes around major capital expenditures are much smaller and more sensitive to performance than those following acquisitions").

[38] *See* Masulis et al., *supra* note 34, at 1853 ("[A]cquisition announcements made by firms with more [takeover defenses] in place generate lower abnormal bidder returns than those made by firms with fewer [takeover defenses], and the difference is significant both statistically and economically."); Harford et al., *supra* note 26, at 248 ("The post-merger operating performance for acquisitions by entrenched managers is worse than for others, suggesting that poor target selection, as opposed to simply overpaying for good targets, explains the value destruction.").

[39] Fu et al., *supra* note 25, at 26.

[40] *See* Harford et al., *supra* note 25, at 247–248.

[41] *See* Fuller et al., *What Do Returns to Acquiring Firms Tell Us? Evidence from Firms That Make Many Acquisitions*, 57 J. Fin. 1763, 1764 (2002) ("[B]idders have significantly negative returns when buying public targets and significantly positive returns when buying private or subsidiary targets.").

company target affects the acquisition decision. The same study found that when entrenched managers buy a private target, they are less likely to use stock, "thereby avoiding scrutiny and the creation of a monitoring blockholder."[42]

A second, complementary contributor to bidder overpayment is behavioral bias,[43] such as overconfidence and ego gratification.[44] Managers may overestimate their ability to price a target accurately or their ability to integrate its operations and generate synergies.[45] They may also get caught up in the competitive dynamic of a bidding contest, leading to the winner's curse.[46] Studies have shown that

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[42] Harford et al., *supra* note 25, at 260.

[43] *See supra* note 4.

[44] See James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L.J. 1333, 1354–81 (2001) (finding that impulses, over-optimism, and anchoring are psychological factors affecting mega-mergers). *See generally* Steinbach et al., *supra* note 35, at 73 (examining the influence of individual executive characteristics on acquisition behavior).

[45] See Mathew L. A. Hayward & Donald C. Hambrick, *Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris*, 42 ADMIN. SCI. Q., 103, 103 (1997) (studying 106 large acquisitions and finding that "losses in acquiring firms' shareholder wealth following an acquisition and the greater the CEO hubris and acquisition premiums, the greater the shareholder losses"); Ulrike Malmendier & Geoffrey Tate, *Who Makes Acquisitions? CEO Overconfidence and the Market's Reaction*, 89 J. FIN. ECON. 20, 20, 34, 42 (2008) (reviewing a sample of Forbes 500 firms from 1980 to 1994 using two proxies for overconfidence, and finding "that the odds of making an acquisition are 65% higher if the CEO is classified as overconfident," and that "[t]he effect is largest if the merger is diversifying and does not require external financing"); Roll, *supra* note 4, at 199–201 (arguing that over-confident managers tend to be overly optimistic when valuing targets and accordingly make value-destroying acquisitions); *see also* Black, *supra* note 3, at 624 ("Managers who are successful in one business may be especially prone to overestimate their ability to run another business."); Ulrike Malmendier & Geoffrey Tate, *CEO Overconfidence and Corporate Investment*, 60 J. FIN. 2661, 2661 (2005) ("Overconfident managers overestimate the returns to their investment projects and view external funds as unduly costly."); *cf.* Arijit Chatterjee & Donald C. Hambrick, *It's All About Me: Narcissistic Chief Executive Officers and Their Effects on Company Strategy and Performance*, 52 ADMIN. SCI. Q. 351, 351–52 (2007) (arguing that narcissistic CEOs favor strategic dynamism and grandiosity, and tend to deliver extreme and volatile performance for their organizations). Confirmation bias, in which a decision-maker notices and emphasizes confirmatory evidence while ignoring or discounting disconfirming evidence, is also a factor. *See, e.g.*, Vicki Bogan & David Just, *What Drives Merger Decision Making Behavior? Don't Seek, Don't Find, and Don't Change Your Mind*, 72 J. ECON. BEHAVIOR & ORG. 930, 932 (2009) (noting that confirmation bias affects merger decisions).

[46] *See, e.g.,* Deepak Malhotra, *The Desire to Win: The Effects of Competitive Arousal on Motivation and Behavior*, 111 ORG. BEHAVIOR & HUMAN DECISION PROCESSES 139, 139 (2010) (examining "when and why potentially self-damaging competitive motivations and behaviors will emerge"); Deepak Malhotra et al., *When Winning Is Everything*, HARV. BUS. REV., May 2008, at 78, 80 (identifying "three principal drivers of competitive arousal in business

social factors can undermine decision making and lead to poor acquisitions. These factors include the existence of extensive business or educational ties between the managers of the bidder and target firms,[47] the presence of fewer independent directors on the bidder's board,[48] and the desire to keep up with peers.[49]

There is reason to think that the involvement of contingently compensated financial advisors can magnify the effects of managerial agency costs. Like managers, financial advisors receive outsized benefits from completing acquisitions. Investment banks get big fees for advising companies on M&A transactions.[50] Their fees are based primarily on the size of the deal, and a significant portion is contingent on closing.[51] It is not uncommon for an advisor

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settings: rivalry, time pressure, and audience scrutiny"). *But see* Mark Humphery-Jenner, Ronald W. Masulis & Peter L. Swan, *Do Wealth Creating Mergers and Acquisitions Really Hurt Bidder Shareholders?* 20, (FIRN Research Paper 2517209, Feb. 14, 2017), https://ssrn.com/abstract=2517209 (finding that bidder stock falls in response to exogenous bid failure, and arguing that "[i]f bids are value destroying or bidders are subject to hubris and overpay, as is often contended, then bid failure should greatly improve bidder value, not destroy it").

[47] *See, e.g.*, Joy Ishii & Yuhai Xuan, *Acquirer-Target Social Ties and Merger Outcomes*, 112 J. FIN. ECON. 344, 346 (2014) (studying 539 mergers between publicly-traded U.S. firms over the period 1999 through 2007 and finding that significant social connections between bidder and target management, derived from educational background and employment history, are associated with lower value creation post-merger and a greater likelihood of subsequent divestment for performance reasons).

[48] *See* Hayward & Hambrick, *supra* note 45, at 117–18 (finding that the relationship between CEO hubris and acquisition premiums is stronger when the CEO is chair of the board and the board has a high proportion of inside directors).

[49] *See* Wei Shi, Yan Zhang, and Robert E. Hoskisson, *Ripple Effects of CEO Awards: Investigating the Acquisition Activities of Superstar CEOs' Competitors*, 38 STRATEGIC MGMT. J. 2080, 2080 (2017) (finding that "CEOs engage in more intensive acquisition activities in the period after their competitors won CEO awards . . . compared to the pre-award period" and that acquisitions during the post-award period "realize lower announcement returns compared to acquisitions by the same CEOs in the pre-award period"); James D. Westphal, Marc-David L. Seidel & Katherine J. Stewart, *Second-Order Imitation: Uncovering Latent Effects of Board Network Ties*, 46 ADMIN. SCI. Q. 717, 723–724 (2001) (finding that firms tend to mimic the acquisition behavior of firms that they are connected to through interlocking directorships); Haleblian et al., *supra* note 26, at 477 (discussing similar research).

[50] *See* Robyn M. McLaughlin, *Investment-Banking Contracts in Tender Offers*, 28 J. FIN. ECON. 209, 209 (1990) (finding that "investment-banker advisory fees in tender offers average 1.29% of the value of a completed transaction"). For investment banks, M&A advisory fees are as important as equity underwriting fees. Mine Ertugrul & Karthik Krishnan, *Investment Banks in Dual Roles: Acquirer M&A Advisors as Underwriters*, 37 J. FIN. RESEARCH 159, 159 (2014); Andrey Golubov et al., *When it Pays to Pay Your Investment Banker: New Evidence About the Role of Financial Advisors in M&As*, 67 J. FIN. 271, 288 (2012).

[51] *See* Andrew F. Tuch, *Banker Loyalty in Mergers and Acquisitions*, 94 TEX. L. REV. 1079, 1097–1098 (2016) ("[F]ees are typically calculated as a percentage of the deal consideration,

to earn tens of millions of dollars for a single transaction, as long as the transaction closes.[52] Advisors also gain prestige from working on successful deals, as measured by their ranking on the "league tables."[53]

There is also reason to think that deal advisors may reinforce the effects of behavioral bias. Advisors are "at the forefront of the negotiations and decision-making process."[54] Advisors have "close and frequent" contact with management and will be "brought into the client's inner sanctum, becoming privy to managers' confidences."[55] If management wants to complete a deal, then a close relationship between management and the financial advisors may lead the advisor to shade its advice in favor of the transaction in order to "avoid displeasing management."[56] This channel may extend to valuation advice, including fairness opinions.[57] Empirical evidence indicates that bidders who obtain fairness opinions underperform in the short term, suggesting that the bankers may be overvaluing the target to help get the deal closed.[58]

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often between 0.5% and 1.0%, contingent on the contemplated deal closing." (citation omitted)).

[52] *Id.* at 1097.

[53] Golubov et al., *supra* note 50, at 277. Similar incentives apply to deal lawyers. *See* C.N.V. Krishnan & Ronald W. Masulis, *Law Firm Expertise and Merger and Acquisition Outcomes*, 56 J. L. & ECON. 189, 220 (2013) (finding that top-tier bidder law firms, as measured by appearance on league tables, are associated with higher rates of deal completion and higher takeover premia than less prestigious law firms; positing that "top bidder law firms have stronger incentives and abilities than less prominent law firms to successfully complete M&A offers even at the cost of higher takeover premia").

[54] JOSHUA ROSENBAUM & JOSHUA PEARL, INVESTMENT BANKING: VALUATION, LEVERAGED BUYOUTS, AND MERGERS & ACQUISITIONS 331 (University 2d ed. 2013).

[55] Tuch, *supra* note 51, at 1095–1096.

[56] Tamar Frankel, *The Influence of Investment Banks on Corporate Governance* 357–358, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 357-58 (Claire A. Hill & Brett H. McDonnell, eds., 2012); *see also* Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557, 1587 (2006) (describing the close relationship between investment banking financial managers and corporate management).

[57] *See* Davidoff, *supra* note 56, at 1586–87 (noting that conflicts may arise for financial advisors because compensation for fairness opinions are dependent upon a transaction's occurrence); *see also* Anup Agrawal et al., *Common Advisers in Mergers and Acquisitions: Determinants and Consequences*, 56 J.L. & ECON. 691, 692 (2013) (stating that advisors have an incentive to complete deals, which can cause "quality to take a back seat").

[58] Joan MacLeod Heminway, *A More Critical Use of Fairness Opinions as a Practical Approach to the Behavioral Economics of Mergers and Acquisitions*, 12 TRANSACTIONS: TENN. J. BUS. L. 81, 85 (2011).

III. ENHANCED SCRUTINY AS A POSSIBLE RESPONSE

In corporate law, agency costs and behavioral biases map onto the law of fiduciary duties. The buy-side directors and officers who confront conflicts of interest and labor under subtle behavioral biases are fiduciaries who owe duties of loyalty and care to the corporation and its stockholders.[59] As the beneficiaries of those duties, stockholders can bring litigation challenging whether directors have complied with their fiduciary obligations. Delaware law has developed a nuanced framework for reviewing the decisions of sell-side fiduciaries, and that framework has implications for judicial review of buy-side decision-making.

A. ENHANCED SCRUTINY AS AN INTERMEDIATE STANDARD OF REVIEW

In a series of landmark decisions issued during the 1980s and early 1990s, the Delaware Supreme Court first created and then developed an intermediate standard of review that stood in between the deferential business judgment rule and the intrusive entire fairness test.[60] In each case, the Delaware Supreme Court confronted a scenario where the contextual realities raised questions about the motives of even independent and disinterested

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[59] *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) (describing corporate directors as fiduciaries who owe duties of care and loyalty); *accord Polk v. Good*, 507 A.2d 531, 536 (Del. 1986) ("In performing their duties the directors owe fundamental fiduciary duties of loyalty and care."); Mills Acq. Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) ("[D]irectors owe fiduciary duties of care and loyalty."). The Delaware Supreme Court has held that corporate officers owe the same fiduciary duties as directors. *See* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009). For simplicity, this discussion speaks in terms of directors, but the analysis applies equally to the duties owed by officers. It bears noting that "[o]fficers also are agents who report to the board of directors in its capacity as the governing body of the corporation" and who therefore owe fiduciary duties to shareholders under agency law. Amalgamated Bank v. Yahoo! Inc., 132 A.3d 752, 780–81 (Del. Ch. 2016). This article does not explore the potentially different implications of the officers' agency-based duties.

[60] Many commentators have made this observation. *See, e.g.,* Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 Del. J. Corp. L. 769, 796 (2006) (describing Delaware Supreme Court's creation of an intermediate standard of review between the entire fairness and business judgment rule standards); Ronald J. Gilson, Unocal *Fifteen Years Later (And What We Can Do About It)*, 26 Del. J. Corp. L. 491, 496 (2001) (explaining that to address the subtle conflicts created by a hostile takeover, "the Delaware Supreme Court chose the middle ground that had been championed by no one. The court unveiled an intermediate standard of review, somewhere between the duty of care and the duty of loyalty").

directors.[61] The situations did not involve the traditional conflicts of interest that corporate law historically had addressed, such as self-dealing, material financial entanglements, or fealty to an interested party. Yet the divergent incentives that arose in these situations did not comfortably permit deferring fully to the directors' judgment as if they were independent and disinterested.[62]

Each time the Delaware Supreme Court confronted one of the scenarios, it responded with a two-part test containing the same core elements. The first step involved examining the directors' motives to determine whether they had acted for a legitimate corporate purpose after conducting a reasonable investigation. The second step involved evaluating the means the directors chose to achieve their purpose to determine whether it fell within a range of reasonable approaches. For both steps, the Delaware Supreme Court placed the burden of proof on the directors, because the confidence-undermining dynamics of the situation created the potential for a loyalty breach. The result was an intermediate standard of review that was more intrusive than the presumptions of the business judgment rule and the rationality standard that it deployed, yet more deferential than the fairness rubric of the entire fairness test.[63]

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[61] *See* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del. 1994) ("[T]here are rare situations which mandate that a court take a more direct and active role in overseeing the decisions made and actions taken by directors. In these situations, a court subjects the directors' conduct to enhanced scrutiny to ensure that it is reasonable."); Gilbert v. El Paso Co., 575 A.2d 1131, 1145 (Del. 1990) (linking the application of enhanced scrutiny to situations in which the board has taken debatable action that carries the "potential for conflict and fiduciary misconduct"); *see also* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 928 (Del. 2003) ("The prior decisions of this Court have identified the circumstances where board action must be subjected to enhanced judicial scrutiny . . . .").

[62] *See In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 597 (Del. Ch. 2010) (describing the concerns that animated the Delaware Supreme Court's foundational enhanced scrutiny decisions; explaining that the Delaware Supreme Court "[a]void[ed] a crude bifurcation of the world into two starkly divergent categories—business judgment rule review reflecting a policy of maximal deference to disinterested board decisionmaking and entire fairness review reflecting a policy of extreme skepticism toward self-dealing decisions" and instead "adopted a middle ground" to address these scenarios); *see also* Golden Cycle, LLC v. Allan, No. Civ.A. 16301, 1998 WL 892631, at *11 (Del. Ch. Dec. 10, 1998) (locating enhanced scrutiny under *Unocal* and *Revlon* between the business judgment rule and the entire fairness test).

[63] *See Dollar Thrifty*, 14 A.3d at 598 ("In that middle ground [of enhanced scrutiny], the reviewing court has leeway to examine the reasonableness of the board's actions under a standard that is more stringent than business judgment review and yet less severe than the entire fairness standard. Moreover, the defendants themselves are allocated the burden to show that they acted reasonably." (footnotes omitted)).

The bulk of the Delaware Supreme Court's generative work on the intermediate standard took place between 1981 and 1995. It started with *Zapata Corporation v. Maldonado*, a path-breaking ruling which created a two-step standard for reviewing a special litigation committee's decision to dismiss a derivative action.[64] Because of potential affinities among directors and the concern that "a 'there but for the grace of God go I' empathy might not play a role,"[65] the Delaware Supreme Court placed the burden on the special litigation committee to prove that its members acted independently and in good faith, had conducted "a reasonable investigation,"[66] and had identified "reasonable bases for good faith findings and recommendations."[67] At that point, the trial court could proceed "in its discretion, to the next step[,]" in which the trial court could "determine, applying its own independent business judgment, whether the motion should be granted."[68] The *Zapata* test provoked an uproar and was roundly criticized for departing from the traditional business judgment rule.[69] With the benefit of hindsight,

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

[65] *Id.* at 787.

[66] *Id.* at 788.

[67] *Id.* at 789.

[68] *Id.* Some have been critical of the concept of a judge's "independent business judgment." *See, e.g., In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 928 (Del. Ch. 2003) (describing the standard as "oxymoronic"). Regarded more charitably, the thrust of the second prong of *Zapata* is not for the court to make a *de novo* assessment, but rather to determine whether the directors reached a reasonable outcome, an analysis that tracks the second prong of enhanced scrutiny. *See* Carlton Invs. v. TLC Beatrice Int'l Holdings, Inc., No. Civ. A. 13950, 1997 WL 305829, at *13 (Del. Ch. May 30, 1997) ("[T]he second prong of the *Zapata* test requires that this court exercise its own business judgment with respect to the reasonableness of the settlement"); *see also* Forsythe v. ESC Fund Mgmt. Co. (U.S.), Inc., C.A. No. 1091-VCL, 2013 WL 458373, at *2 (Del. Ch. Feb. 6, 2013) (discussing range of reasonableness inquiry); Kenneth B. Davis, Jr., *Structural Bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1360 (2005) ("[T]he court's review, as contemplated [by *Zapata*], is of the reasonableness of the [special litigation committee's] business judgment rather than the substitution of its own.").

[69] *See, e.g.*, ROBERT C. CLARK, CORPORATE LAW 647–48 (1986) (describing contretemps over *Zapata*); Irwin Borowski, *Corporate Accountability: The Role of the Independent Director*, 9 J. CORP. L. 455, 466 (1984) ("In 1981, however, the Delaware Supreme Court, in *Zapata Corp. v. Maldonado*, surprised almost everybody by requiring an independent judicial review in which the court applies its own independent business judgment to the allegations in order to determine whether the suit should be allowed to continue. The *Zapata* decision aroused a storm of controversy with numerous articles being written in its aftermath." (footnotes omitted)).

the *Zapata* two-step analysis is now easily recognizable as a nascent version of enhanced scrutiny.[70]

Then came the "watershed year"[71] of 1985, when the Delaware Supreme Court formally created the intermediate standard of review in the iconic *Unocal* decision.[72] The court promptly applied the new standard in *Moran*,[73] which validated the adoption of a stockholder-rights plan as an anticipatory defensive measure. The court also extended the new standard to the sale of a corporation in *Revlon*.[74] These decisions followed the judicial bombshell of *Van*

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[70] *See* Obeid v. Hogan, C.A. No. 11900-VCL, 2016 WL 3356851, at *13 (Del. Ch. June 10, 2016) ("With the benefit of hindsight, one can discern in *Zapata* the foundational concepts that animate enhanced scrutiny, the intermediate standard of review that the Delaware Supreme Court introduced openly some four years later in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)."); *In re* EZCORP Inc. Consulting Agreement Derivative Litig., C.A. No. 9962-VCL, 2016 WL 301245, at *27 (Del. Ch. Jan. 25, 2016) (describing *Zapata* as having adopted "a test which marked the Delaware Supreme Court's first deployment of something akin to the two-step standard of review that later emerged as enhanced scrutiny"); La. Mun. Police Emps. Ret. Sys. v. Morgan Stanley & Co., Inc., C.A. No. 5682-VCL, 2011 WL 773316, at *7 (Del. Ch. Mar. 4, 2011) ("[A special litigation committee's] decision to dismiss a post-demand-excusal derivative claim is reviewed under *Zapata*'s two-step standard, which effectively amounts to reasonableness review and a context-specific application of enhanced scrutiny."); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 851 (2004) (concluding that "*Zapata* is thus quite similar to *Unocal*"); Gregory V. Varallo, et al., *From* Kahn *to* Carlton*: Recent Developments in Special Committee Practice*, 53 BUS. LAW. 397, 423 n.121 (1998) ("The [*Zapata*] standard is also reminiscent of the enhanced scrutiny courts use to examine the actions of directors engaged in a sale of a corporation or other like transactions . . . . Perhaps the similarity . . . is best explained by the fact that in all of these situations courts would like to defer to the business judgment of a board, but because the scenarios in which these cases arise create a potential conflict of interest for board members, the court is only willing to do so if a board first demonstrates it is capable of making an independent business judgment and the judgment seems at least to make some rational sense.").

[71] E. Norman Veasey, *Book Review*, 15 Del. J. Corp. L. 573, 576 (1990) (reviewing DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS (3d ed. 1989)); *accord* E. Norman Veasey, *Counseling Directors in the New Corporate Culture*, 59 BUS. LAW. 1447, 1447 (2004) ("The watershed year of 1985, featuring *Smith v. Van Gorkom*, *Unocal*, *Moran v. Household*, and *Revlon*, was indeed a time when many of the rules of the road did change in the context of mergers and acquisitions." (citations omitted)). The four written opinions were issued during a fourteen-month period between January 1985 and March 1986. But while the Delaware Supreme Court published the written decision in *Revlon* on March 13, 1986, outside the calendar year, the high court issued its injunction ruling orally from the bench on November 1, 1985, within the watershed. Revlon, Inc. v. MacAndrews & Forbes Hldgs., 506 A.2d 173 (Del. 1986).

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

[73] Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985).

[74] *Revlon*, 506 A.2d 173.

Gorkom,[75] which kicked off the watershed year by holding directors personally liable for breaching their fiduciary duties when selling a corporation for cash in a single-bidder process that the court deemed inadequate. *Van Gorkom* did not openly apply the new intermediate standard—it would not be created until five months later in *Unocal*. Only later did a consensus emerge that *Van Gorkom* was a proto-enhanced-scrutiny case that applied the intermediate standard, albeit without saying so.[76]

Over the next decade, Delaware's enhanced scrutiny jurisprudence grew vigorously—though not always consistently—as the Delaware Supreme Court and the Delaware Court of Chancery applied the precedents from the watershed year to diverse fact patterns involving third-party M&A scenarios.[77] For multiple

[75] Smith v.Van Gorkom 488 A.2d 858 (Del. 1985), *overruled in part on other grounds by* Gantler v. Stephens, 965 A.2d 695, 713 n.54 (Del. 2009).

[76] *See Dollar Thrifty*, 14 A.3d at 602 ("*Van Gorkom*, after all, was really a Revlon case." (footnotes omitted)); Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1051 n.4 (Del. Ch. 1996) ("I count [*Van Gorkom*] not as a 'negligence' or due care case involving no loyalty issues but as an early and, as of its date, not yet fully rationalized, '*Revlon*' or 'change in control' case."); William T. Allen, Jack B. Jacobs, & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of* Van Gorkom *and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 459 n.39 (2002) ("*Van Gorkom* . . . must also be viewed as part of the Delaware courts' effort to grapple with the huge increase in mergers and acquisition activity in [the] 1980s and the new problems that posed for judicial review of director conduct."); William T. Allen, *The Corporate Director's Fiduciary Duty of Care and the Business Judgment Rule Under U.S. Corporate Law*, *in* COMPARATIVE CORPORATE GOVERNANCE—THE STATE OF THE ART AND EMERGING RESEARCH 307, 325 (Klaus J. Hopt et al. eds., 1998) ("In retrospect, [*Van Gorkom*] can be best rationalized not as a standard duty of care case, but as the first case in which the Delaware Supreme Court began to work out its new takeover jurisprudence."); Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 522 (2002) ("*Van Gorkom* should be seen not as a business judgment rule case but as a takeover case that was the harbinger of the then newly emerging Delaware jurisprudence on friendly and hostile takeovers, which included the almost contemporaneous *Unocal* and *Revlon* decisions." (footnote omitted)); Jonathan R. Macey & Geoffrey P. Miller, Trans Union *Reconsidered*, 98 YALE L. J. 127, 128 (1988) ("*Trans Union* is not, at bottom, a business judgment case. It is a takeover case."); *see also* Stephen M. Bainbridge, *Why A Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 51–52 (2002) (interpreting "the oft-maligned decision in *Smith v. Van Gorkom*" as addressing a breakdown in the group decision-making process in which the board "blindly relied on Van Gorkom's assertion," thereby enabling Van Gorkom to not disclose and the board to not discover "key facts suggesting that the deal was not as attractive as it seemed on first look").

[77] The reference to third-party M&A scenarios encompasses transactions negotiated at arms' length, or a board's arms' length resistance to a hostile bid. It excludes scenarios where the counterparty is a controlling stockholder, or where a majority of the directors have a traditional conflict of interest resulting from direct transaction-related benefits. The latter

reasons, including the novelty of the new intermediate standard and the fact that each of the foundational cases necessarily dealt with a unique fact scenario, real-time observers frequently interpreted the core decisions as creating distinct and unrelated standards of review. The decisions in *Unocal* and *Revlon*, for example, were perceived frequently as establishing separate doctrines, with the latter imposing affirmative conduct obligations on directors.[78]

By 1995, however, the tide of jurisprudential innovation began to ebb. The high-water mark was the Delaware Supreme Court's 1994 opinion in *QVC*,[79] which countered a largely restrictive ruling in *Time-Warner*[80] by restoring enhanced scrutiny to stock-for-stock mergers involving a change of control. During the ensuing nineteen years that preceded recent wholesale changes in the composition of the Delaware Supreme Court,[81] the Delaware Supreme Court

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two transactional categories had long been governed by the entire fairness test, and during the fertile period when the Delaware courts developed the intermediate standard of enhanced scrutiny, the application of the entire fairness standard to controller transactions remained relatively non-controversial and stable. *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983). The principal doctrinal development for controlling stockholder transactions took place in the mid-1990s, when the Delaware Supreme Court held that the threat of inherent coercion created by the presence of a controlling stockholder meant that the use of a special committee of independent directors was not sufficient to restore business judgment review. *See generally* Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997); Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110 (Del. 1994). Recent Delaware Supreme Court decisions exhibit considerable development in this area. *See In re* Cornerstone Therapeutics Inc., S'holder Litig., 115 A.3d 1173 (Del. 2015) (holding that the presence of controller and the threat of inherent coercion are insufficient to call into question independence and disinterestedness of a director for purposes of pleading a claim for breach of fiduciary duty that would overcome exculpation under 8 Del. Code Ann. § 102(b)(7) (2015)); Kahn v. M & F Worldwide Corp., 88 A.3d 635 (Del. 2014) (holding that use of both a special committee and a majority-of-the-minority vote *ab initio* are sufficient to negate the threat of inherent coercion and cause the operative standard of review to be the business judgment rule).

[78] *See* Bainbridge, *supra* note 60, at 802 ("[F]or many, the differences between *Unocal* and *Revlon* loomed large." (citation omitted)); Ross W. Wooten, Comment, *Restructurings During A Hostile Takeover: Directors' Discretion or Shareholders' Choice?*, 35 HOUS. L. REV. 505, 519 (1998) ("It is apparent that there are two standards . . . ."); Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: The Impact of* QVC *and Its Progeny*, 32 HOUS. L. REV. 945, 962 (1995) ("[T]here is much practical difference between the *Unocal* and *Revlon* modes of analysis.").

[79] Paramount Commc'ns Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994).

[80] Paramount Commc'ns, Inc. v. Time Inc. (Time-Warner), 571 A.2d 1140 (Del. 1990).

[81] Between 2014 and 2017, the entire composition of the five-member Delaware Supreme Court turned over. *See Historical List of Delaware Supreme Court Justices (1951 to Present)*, Delaware Courts, http://courts.delaware.gov/supreme/hisort/justiceslist.aspx (last visited Sept. 27, 2018) (listing the tenure, names and roles of Delaware Supreme Court judges). The

issued relatively few enhanced scrutiny opinions.[82] The initial decisions during the interregnum focused on refining existing doctrine.[83] With perhaps the exception of *MM Companies, Inc.* and *Omnicare, Inc.*,[84] the later decisions made only interstitial or liminal

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changes included the elevation to Chief Justice of the Honorable Leo E. Strine, Jr., a longtime member of the Court of Chancery and leading voice on that court. *Id.* By contrast, between 2004 and 2012, no changes took place in the high court's membership, and from 1995 until 2004, only four changes took place. *Id.*

[82] A Westlaw search for Delaware Supreme Court decisions that mention *Unocal* or *Revlon* generates a total of 34 decisions during the 19 years between 1995 and 2014, or 1.8 per year. Most of the decisions only mention *Unocal* or *Revlon* in passing; a much smaller number engage with the doctrinal issues (admittedly this is a subjective assessment). Since 2014, the Delaware Supreme Court has issued 11 decisions that mention *Unocal* or *Revlon*, or nearly 3.7 per year. Several have had significant implications for enhanced scrutiny doctrine. *See* Singh v. Attenborough, 137 A.3d 151, 151–53 (Del. 2016) (holding that after a fully informed, non-coerced stockholder vote lowers the standard of review from enhanced scrutiny to the business judgment rule, a plaintiff cannot seek to rebut the business judgment rule using issues that were disclosed to stockholders, and that a claim for waste is not viable because stockholder approval demonstrates that the transaction could be considered beneficial); Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 308 (Del. 2015) (holding a fully informed, non-coerced stockholder vote lowers the standard of review from enhanced scrutiny to the business judgment rule); C & J Energy Servs., Inc. v. Miami Gen. Emps.' & Sanitation Emps.' Ret. Tr., 107 A.3d 1049, 1067–68, 1071–72 (Del. 2014) (reversing issuance of preliminary injunction; finding management-led, single-bidder strategy to be reasonable under enhanced scrutiny; rejecting use of targeted injunctive relief to address breaches of fiduciary duty and requiring that any injunction block the transaction as a whole; prioritizing contract claims of acquirer). A similarly recent high court decision addressing the implications of controller-level conflicts for purposes of exculpation has logical implications for enhanced scrutiny as well, which addresses less substantial, more subtle conflicts. *See Cornerstone Therapeutics*, 115 A.3d at 1184–87 and *supra* note 77.

[83] *See In re* Santa Fe Pacific Corp. S'holder Litig., 669 A.2d 59, 71 (Del. 1995) (formalizing situational triggers for enhanced scrutiny under *Revlon* as "(1) when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company;" (2)"where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company," or (3) "when approval of a transaction results in a sale or change of control" (internal quotations and citations omitted)); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1367 (Del. 1995) (modifying reasonableness aspect of enhanced scrutiny under *Unocal* to include the range-of-reasonableness concept from *QVC* and to specify that reasonable defensive measures could not be preclusive or coercive); Arnold v. Soc'y for Sav. Bancorp., 650 A.2d 1270, 1290 (Del. 1994) (same).

[84] From a doctrinal standpoint, the principal exception is *MM Companies, Inc. v. Liquid Audio, Inc.*, which expounded on the application of enhanced scrutiny to voting issues. 813 A.2d 1118, 1131 (Del. 2003). Reasonable minds can disagree about *Omnicare, Inc. v. NCS Healthcare, Inc.* 818 A.2d 914 (Del. 2003). Technically that decision was limited and incremental in that it (i) reaffirmed the Delaware Supreme Court's holding in *Time-Warner* that enhanced scrutiny applied to defensive measures in a merger agreement, even if the merger itself was not subject to enhanced scrutiny, and (ii) held that a combination of defensive measures failed enhanced scrutiny by rendering the transaction preclusive. *Id.*

refinements.[85] After an extended bull market in judicial creativity and doctrinal innovation, a fallow period was perhaps both expected and welcome.

The Delaware courts' major achievement during the fallow period was to break down the seemingly artificial barriers between the initially divergent strains of enhanced scrutiny. The Delaware Supreme Court reiterated that *Revlon* did not impose conduct obligations on directors,[86] and a series of Court of Chancery decisions, primarily authored by Chief Justice Strine during his

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Many commentators, however, consider the decision's analysis, particularly on the latter issue, to have gone well beyond prior doctrine. A smaller group of commentators have argued that the widespread criticism of *Omnicare*, although valid in some respects, became self-reinforcing and overwrought, such that the resulting clamor drowned out conceptually sound and doctrinally helpful features of the decision. *See generally* Megan Wischmeier Shaner, *How "Bad Law, Bad Economics and Bad Policy" Positively Shaped Corporate Behavior*, 47 AKRON L. REV. 753 (2014) (collecting criticisms of *Omnicare*, showing that the predicted negative consequences have not come to pass, and identifying positive features of decision); Megan Wischmeier Shaner, *Revisiting* Omnicare*: What Does Its Status 10 Years Later Tell Us?*, 38 J. CORP. L. 865, 889 (2013) (arguing that the decision made positive contributions including (i) establishing that enhanced scrutiny applies to defensive measures in stock-for-stock merger agreements and (ii) reinforcing the need for boards to be active and involved in merger transactions); J. Travis Laster, Omnicare's *Silver Lining*, 38 J. CORP. L. 795, 796 (2013) (arguing that "like people, problems, and broken hearts, *Omnicare* isn't all bad" and that "[a]lthough saying anything good about *Omnicare* smacks of heresy, four aspects of the decision deserve positive reinforcement"); Brian J.M. Quinn, *Bulletproof: Mandatory Rules for Deal Protection*, 32 J. CORP. L. 865, 885 (2007) (arguing that regardless of theoretical and doctrinal weaknesses in its decision, *Omnicare* reached the right policy result by limiting fully locked-up transactions).

[85] *See* Versata Enters., Inc. v. Selectica, Inc., 5 A.3d 586, 601 (Del. 2010) (holding that a defensive measure is preclusive for purposes of enhanced scrutiny if it makes success "realistically unattainable" and that standard did not require "mathematical impossibility" (citing *Unitrin*, 651 A.2d at 1387)); Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291–92 (Del. 1998) (applying *Moran* to affirm injunction against rights plan with deferred redemption feature); *cf.* Black v. Hollinger Int'l, Inc., 872 A.2d 559, 567–68 n.16 (Del. 2005) (affirming Court of Chancery judgment on limited grounds; cautioning that "our upholding the adoption of the Rights Plan should be understood as limited to the specific, rather extreme, circumstances of this case" and "should not be viewed as creating any broad exception to the transaction paradigm in which rights plans are normally designed to operate: settings involving a change of control transaction at the level of the corporate entity whose board of directors adopts the rights plan").

[86] *See, e.g.,* Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 242 (Del. 2009) ("No court can tell directors exactly how to accomplish [the goal of obtaining the best value reasonably available], because they will be facing a unique combination of circumstances, many of which will be outside their control."); Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989) ("[T]here is no single blueprint that a board must follow to fulfill its duties."); Macmillan, 559 A.2d at 1286 ("Directors are not required by Delaware law to conduct an auction according to some standard formula . . . .").

tenure on the court, explained that *Revlon* operates as a form of reasonableness review, i.e., a manifestation of enhanced scrutiny.[87] The reconstituted Delaware Supreme Court, led by Chief Justice Strine, has continued to describe *Revlon* in these terms.[88]

Perhaps most importantly, during his time on the Court of Chancery, Chief Justice Strine laid the analytical groundwork for understanding enhanced scrutiny as a single, intermediate standard of review. This standard applies "when there is a basis for concern that directors without a pure self-dealing motive might be influenced by considerations other than the best interests of the corporation and other stockholders."[89] Because of the subtle

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[87] *See Dollar Thrifty*, 14 A.3d at 595–96 ("[A]lthough the level of judicial scrutiny under *Revlon* is more exacting than the deferential rationality standard applicable to run-of-the-mill decisions governed by the business judgment rule, at bottom *Revlon* is a test of reasonableness; directors are generally free to select the path to value maximization, so long as they choose a reasonable route to get there." (footnote omitted)); *In* re Netsmart Techs., Inc. S'holders Litig., 924 A.2d 171, 192 (Del. Ch. 2007) ("What is important and different about the Revlon standard is the intensity of judicial review that is applied to the directors' conduct. Unlike the bare rationality standard applicable to garden-variety decisions subject to the business judgment rule, the *Revlon* standard contemplates a judicial examination of the reasonableness of the board's decision-making process."); *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1000 (Del. Ch. 2005) ("[In *Revlon*,] the Supreme Court held that courts would subject directors . . . to a heightened standard of reasonableness review, rather than the laxer standard of rationality review applicable under the business judgment rule."); *see generally* J. Travis Laster, Revlon *is a Standard of Review: Why It's True and What It Means*, 19 FORDHAM J. CORP. & FIN. L. 5 (2013) (collecting authorities).

[88] *See* RBC Capital Markets, LLC v. Jervis, 129 A.3d 816, 849 (Del. 2015) ("*Revlon* 'requires us to examine whether a board's overall course of action was reasonable under the circumstances as a good faith attempt to secure the highest value reasonably attainable.'" (quoting C & J Energy Servs., Inc. v. Miami Gen. Emps.' & Sanitation Emps.' Ret. Tr., 107 A.3d 1049, 1066 (Del. 2014))).

[89] *Dollar Thrifty*, 14 A.3d at 599 n.181 (citation omitted). The Delaware Supreme Court has not yet gone so far as to say openly that there is a single, intermediate standard of enhanced scrutiny, but it has come close. The Delaware Supreme Court's decision in *QVC* can be viewed as a step towards a unified intermediate standard of review. *See* Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty Law After* QVC *and* Technicolor*: A Unified Standard (and the End of* Revlon *Duties)*, 49 BUS. LAW. 1593, 1612 (1994). This interpretation of *QVC* becomes more powerful when that decision is considered in conjunction with *Unitrin*, a case from one year later. The two decisions use virtually identical language and concepts, even though *QVC* was indisputably a so-called *Revlon* case and *Unitrin* was indisputably a so-called *Unocal* case. More recently, the Delaware Supreme Court discussed enhanced scrutiny as a single, intermediate standard of review in *Omnicare*. *See* 818 A.2d at 928 (describing "enhanced judicial scrutiny" as a standard of review triggered by specific circumstances identified by "prior decisions of this Court"); *id.* at 931 (describing "Enhanced Scrutiny Generally" and drawing on *QVC* and *Untirin* to formulate a generalized two-part test). The popular sentiment against finding anything of value in *Omnicare*, which

conflicts inherent in these scenarios, the directors' motivations become ambiguous. A course of action such as adopting a stockholder rights plan, could have been taken in good faith for the loyal purpose of advancing stockholder interests, or the same course of action could have been pursued—consciously or subconsciously—because of the directors' personal interests or for other confounding reasons.

Consequently, "there is a predicate question that must be answered that is not typically at issue in a case governed by the business judgment rule."[90] When the business judgment rule applies, the board is presumed to be disinterested "and thus has no apparent motive to do anything other than act in the best interests of the corporation and its stockholders."[91] But in a situation where enhanced scrutiny applies, the predicate question of what the board's true motivation was comes into play, and "[t]he court must take a nuanced and realistic look at the possibility that personal interests short of pure self-dealing have influenced the board."[92] The resulting concern about the directors' motives is addressed "by requiring that the directors demonstrate that their decision was well-motivated and was a reasonable way to advance the proper interests they must serve, which are the best interests of the corporation and the stockholders."[93]

The court carries out the necessary analysis in two steps. Framed generally, the first step requires that that the defendant fiduciaries "bear the burden of persuasion to show that their motivations were proper and not selfish."[94] Put differently, "the directors must at a minimum convince the court that they have not acted for an

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admittedly is not a perfect decision, appears to have foreclosed recognition of this doctrinally positive step. *See* Laster *supra* note 84, at 796.

[90] *Dollar Thrifty*, 14 A.3d at 598.

[91] *Id.*

[92] *Id.; accord* Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786, 807 (Del. Ch. 2007) ("*Unocal,* when applied faithfully, . . . requires directors to convince the court that their actions are motivated by a good faith concern for the stockholders' best interests, and not by a desire to entrench or enrich themselves."); *id.* (explaining that *Unocal* analysis "subsumes the question of loyalty that pervades all fiduciary duty cases, which is whether the directors have acted for proper reasons").

[93] *Dollar Thrifty*, 14 A.3d at 599 n.181; *accord Mercier*, 929 A.2d at 807 ("The core of *Unocal*'s utility really rests in the burden it asserts on directors to: (1) identify the proper corporate objectives served by their actions; and (2) justify their actions as reasonable in relationship to those objectives.").

[94] *Mercier*, 929 A.2d at 810.

inequitable purpose" by persuading the court that "their actions are motivated by a good faith concern for the stockholders' best interests, and not by a desire to entrench or enrich themselves."[95] During the first phase of an enhanced scrutiny analysis, the court examines the evidence surrounding the reasons that the directors' identified contemporaneously for taking action. The court assesses whether the proffered reasons were legitimate.[96] The court also evaluates whether the directors have shown that the grounds they identified had an adequate foundation and reflected their actual motives.[97]

The second step requires that the defendant fiduciaries show that "their actions were reasonable in relation to their legitimate objective."[98] During the second phase, the court examines the fit between the purposes that the directors identified and the means they selected.[99] The reasonableness test supplies an objective standard, but not one that contemplates a single, "reasonable" answer. Rather, a court determines whether the challenged

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[95] *Id.* at 807.

[96] *See QVC*, 637 A.2d at 45 (describing the first step of enhanced scrutiny as requiring "a judicial determination regarding the adequacy of the decisonmaking process employed by the directors, including the information on which the directors based their decision"); *Macmillan*, 559 A.2d 1261 at 1288 (holding that where a board has "treated one or more of the respective bidders on unequal terms," enhanced scrutiny applies, and the directors must show in the first step that they "properly perceived that shareholder interests were enhanced" by disparate treatment); *Unocal*, 493 A.2d at 955 (describing the first step of enhanced scrutiny as requiring that the board demonstrate "reasonable grounds for believing that a danger to corporate policy and effectiveness existed").

[97] *See Mercier*, 929 A.2d at 807 (explaining that enhanced scrutiny "is useful in exposing pre-textual justifications" and by requiring the party exercising authority to justify its actions, "flimsy pretense stands a greater chance of being revealed" (footnotes omitted)); Phillips v. Insituform of N. Am., Inc., Civ. A. No. 9173, 1987 WL 16285, at *7 (Del. Ch. Aug. 27, 1987) (conducting *Unocal* enhanced scrutiny analysis and rejecting a board's proffered justification as pretextual).

[98] *Mercier*, 929 A.2d at 810.

[99] *See QVC*, 637 A.2d at 45 (describing the second step of enhanced scrutiny as requiring "a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing"); *Macmillan*, 559 A.2d at 1288 (holding that where a board has "treated one or more of the respective bidders on unequal terms," enhanced scrutiny applies, and the directors must show in the second step that "the board's action [was] reasonable in relation to the advantage sought to be achieved" by the disparate treatment); *Unocal*, 493 A.2d at 955 (describing the second step of enhanced scrutiny as requiring that the board demonstrate that they adopted a response to an identified takeover threat that was "reasonable in relation to the threat posed").

corporate decision falls within a reasonable range of objectively constrained discretion:

> [A] court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.[100]

The question is not whether the board made a decision which, with the benefit of hindsight, appears optimal, but rather whether the approach that the board selected "was itself a reasonable choice that a loyal and careful board could adopt in the circumstances."[101] Actions that coerce stockholders or which preclude any alternative other than the board-favored option fall outside the range of reasonableness.[102]

Through this two-step examination, the court evaluates whether the board took "a logical and reasoned approach for the purpose of advancing a proper objective, and to thereby smoke out mere pretextual justifications for improperly motivated decisions."[103] The enhanced scrutiny standard thus "requires the court to consider for itself whether the board is truly well motivated (i.e., is it acting for the proper ends?) before ultimately determining whether its means

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[100] *QVC*, 637 A.2d at 45 (emphasis removed).

[101] *Dollar Thrifty*, 14 A.3d at 598-99; *see also In re* Lear Corp. S'holder Litig., 926 A.2d 94, 115 (Del. Ch. 2007) ("The duty to act reasonably is just that, a duty to take a reasonable course of action under the circumstances presented." (footnote omitted)).

[102] *See Mercier*, 929 A.2d at 808 (explaining that the concepts of preclusion and coercion are "useful considerations" for evaluating defensive responses to a takeover bid, protective provisions in a merger agreement, and "director actions influencing the conduct of elections").

[103] *Dollar Thrifty*, 14 A.3d at 598; *accord* Mercier, 929 A.2d at 807 (explaining that enhanced scrutiny is "useful in exposing pre-textual justifications"); *see In re* Topps Co. S'holders Litig., 926 A.2d 58, 91 (Del. Ch. 2007) ("Although Shorin and the other defendants claim that they truly desire to get . . . a topping bid from Upper Deck that they can accept, their behavior belies those protestations."); *id.* ("The Topps board's negotiation posture and factual misrepresentations are more redolent of pretext, than of a sincere desire to comply with their *Revlon* duties.").

were themselves a reasonable way of advancing those ends."[104] Conceived in this fashion, enhanced scrutiny is "reminiscent of some federal Constitutional standards of review, which smoke out the actual objective supposedly motivating challenged governmental action and require a fit (of looser or tighter nature) between that objective and the means used."[105] "Because there is a burden on the party in power to identify its legitimate objectives and to explain its actions as necessary to advance those object[ives], flimsy pretense stands a greater chance of being revealed."[106]

Because the enhanced scrutiny test is ultimately a means of screening for improperly motivated actions, the outcome of the analysis depends heavily on whether the inquiry reveals that a conflicting interest in fact influenced the board's decision. "As one would expect, when the record reveals no basis to question the board's good faith desire to attain the proper end, the court will be more likely to defer to the board's [business] judgment about the means to get there."[107]

B. ENHANCED SCRUTINY FOR SELL-SIDE M&A TRANSACTIONS

Enhanced scrutiny can now be described generally as an intermediate standard of review that applies in "specific, recurring, and readily identifiable situations involving potential conflicts of interest where the realities of the decision making context can subtly undermine the decisions of even independent and disinterested directors."[108] To date, the Delaware Supreme Court has recognized a limited number of specific scenarios in which unilateral board action warrants the application of enhanced scrutiny: (i) resistance to a takeover[109]—whether during an actual

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[104] *Dollar Thrifty*, 14 A.3d at 599–600.

[105] *Mercier*, 929 A.2d at 807 (citation omitted).

[106] *Id.* (citation omitted).

[107] *Dollar Thrifty*, 14 A.3d at 600; *accord id.* at 602 ("The defendants have convinced me that the entire Board was subjectively well motivated and exercised due care. Even in the realm of heightened scrutiny, judicial (law-trained) second guessing of the means chosen by such a (business-experienced) board to maximize value should, one would think, be rare.").

[108] *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 43 (Del. Ch. 2013); *accord* Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 457 (Del. Ch. 2011) ("Enhanced scrutiny applies when the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors.").

[109] *See Unocal*, 493 A.2d at 954 (inventing the enhanced scrutiny standard because when taking defensive action in response to a hostile tender offer, there is an "omnipresent specter

takeover battle or through the advanced implementation of defensive measures;[110] (ii) intervention in an electoral contest for directors or a vote with implications for corporate control;[111] (iii) taking over and addressing validly initiated derivative litigation;[112] and (iv) certain sell-side M&A scenarios.[113]

For purposes of this article, the application of enhanced scrutiny to certain sell-side M&A scenarios is the most relevant. Unfortunately, the development of enhanced scrutiny in this setting has not been a model of clarity, and the doctrine's ebbs and flows

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that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders"); *accord* Stroud v. Grace, 606 A.2d 75, 82 (Del. 1992) ("*Unocal* recognized that directors are often faced with an 'inherent conflict of interest' during contests for corporate control '[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders . . . .'" (quoting *Unocal*, 493 A.2d at 954) (alteration in original))); *see Omnicare*, 818 A.2d at 928 ("The prior decisions of this Court have identified the circumstances where board action must be subjected to enhanced judicial scrutiny . . . . One of those circumstances was described in *Unocal*: when a board adopts defensive measures in response to a hostile takeover proposal . . . .").

[110] *See* Williams v. Geier, 671 A.2d 1368, 1377 n.18 (Del. 1996) ("The fact that no company or person has commenced a specific takeover threat or action at the time of the defensive measure's adoption does not preclude application of the *Unocal* analysis if it is otherwise applicable."); *Stroud*, 606 A.2d at 82 ("The scrutiny of *Unocal* is not limited to the adoption of a defensive measure during a hostile contest for control" and also applies to "a preemptive defensive measure" when the corporation is "not under immediate attack." (internal quotation marks and citation omitted)); *Moran*, 500 A.2d at 1350 (applying enhanced scrutiny to "a defensive mechanism adopted to ward off possible future advances and not . . . in reaction to a specific threat"); *see also Omnicare*, A.2d 914 at 928 ("In *Moran v. Household*, we explained why a *Unocal* analysis also was applied to the adoption of a stockholder's rights plan, even in the absence of an immediate threat.").

[111] *See Mercier*, 929 A.2d at 811 (explaining that when there is director conduct "affecting either an election of directors or a vote touching on matters of corporate control," the board must justify its action under the enhanced scrutiny test (citation omitted)); Apple Computer, Inc. v. Exponential Tech., Inc., No. 16315, 1999 WL 39547, at *4 (Del. Ch. Jan. 21, 1999) (explaining that courts applied enhanced scrutiny to director electoral contests because "the board's duty of loyalty was not necessarily implicated in the traditional sense of self-dealing, but the potential for entrenchment in the face of a hostile acquisition—the type of situation also implicating the *Unocal* standard of intermediate review—did arise"); Aprahamian v. HBO & Co., 531 A.2d 1204, 1206 (Del. Ch. 1987) (explaining that a "candidate for office, whether as an elected official or as a director of a corporation," has a conflict of interest in the election because the candidate "is likely to prefer to be elected rather than defeated" and "therefore has a personal interest in the outcome of the election even if the interest is not financial and he seeks to serve from the best of motives").

[112] *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 785 (Del. 1981).

[113] *See Mercier*, 929 A.2d at 812 ("For nearly a quarter of a century, Delaware law has subjected directors to reasonableness review as to much of their conduct in the M&A context.").

continue to resonate today. As a result, enhanced scrutiny currently does not apply to all third-party sell-side M&A scenarios. It clearly applies to a merger in which stockholders receive cash[114] or where the consideration consists of stock in a company with a controlling stockholder.[115] It does not currently apply to stock-for-stock mergers between widely traded public companies,[116] although it does apply to defensive provisions included in the merger agreements that govern those transactions.[117]

Despite this patchwork quilt of coverage, the reasons enhanced scrutiny applies in this setting are now relatively clear, once again largely due to an analytical foundation established by Chief Justice Strine during his tenure on the Court of Chancery. Put simply, as then-Chancellor Strine explained in his *El Paso* decision, "the potential sale of a corporation has enormous implications for corporate managers and advisors, and a range of human

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[114] *See Topps*, 926 A.2d at 64 (noting how the *Revlon* standard applies to those actions involving cash sales of companies); *In re* TW Services, Inc. S'holders Litig., Civ. A. Nos. 10427, 10298, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989); *see also* Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919, 927 n.25 (2001) ("In its simplest formulation, *Revlon* requires directors who wish to sell the company for cash to take affirmative steps to obtain the highest sale price reasonably available."); Black & Kraakman, *supra* note 76, at 539–40 ("The most common port of entry into *Revlon*[]land is a cash sale . . . . Cash sales . . . are an easy case for limiting the target board's discretion . . . .").

[115] *See QVC*, 637 A.2d at 42-45, 48 (applying enhanced scrutiny to a stock-for-stock merger where the transaction would result in a change of control because the acquirer had a controlling stockholder); *see also Omnicare*, 818 A.2d at 928 ("The prior decisions of this Court have identified the circumstances where board action must be subjected to enhanced judicial scrutiny . . . . such as when the board enters into a merger transaction that will cause a change in corporate control, initiates an active bidding process seeking to sell the corporation, or makes a breakup of the corporate entity investigable." (citations omitted)); *In re* Santa Fe Pac. Co. S'holders Litig., 669 A.2d 59, 71 (Del. 1995) (same); Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1290 (Del. 1994) (same).

[116] *See QVC*, 637 A.2d at 42–48 (interpreting *Time-Warner* as declining to apply enhanced scrutiny to a transaction because both corporations were widely traded and control after the transaction would remain in the market); *see*.

[117] *See Omnicare*, 818 A.2d at 931 (Del. 2003) ("[D]efensive devices . . . must withstand enhanced judicial scrutiny under the *Unocal* standard of review, even when that merger transaction does not result in a change of control." (citations omitted)); *Time-Warner*, 571 A.2d at 1150–51 (rejecting application of enhanced scrutiny to mergers under *Revlon* but holding that defensive measures in merger agreements are "properly subject to a *Unocal* analysis"); *accord* McMillan v. Intercargo Corp., 768 A.2d 492, 506 n.62 (Del. Ch. 2000) ("Under a 'duck' approach to the law, 'deal protection' terms self-evidently designed to deter and make more expensive alternative transactions would be considered defensive and reviewed under the [*Unocal*] standard."); Strine, *supra* note 114, at 934 (arguing for *Unocal* review of defensive measures in stock-for-stock merger agreements).

motivations, including but by no means limited to greed, can inspire fiduciaries and their advisers to be less than faithful."[118] These interests warrant applying enhanced scrutiny to the sale of a corporation, with or without an initial hostile bid.[119]

The divergent interests of advisors also support the application of enhanced scrutiny in third-party M&A scenarios. Investment banks play a "central role . . . in the evaluation, exploration, selection, and implementation of strategic alternatives. . . ."[120] "The senior management suite of an operating company is unlikely to be

[118] *In re* El Paso Corp. S'holder Litig., 41 A.3d 432, 439 (Del. Ch. 2012) (considering a transaction in which management contemplated a later management buy-out involving certain assets); *see Lear*, 926 A.2d at 114–15 (concluding that there is a reasonable probability that a CEO nearing retirement was motivated to sell by his desire to secure his nest egg); *Topps*, 926 A.2d at 88 (observing that the directors' tepid response to a topping bidder "regrettably suggests that the Topps Incumbent Directors favored Eisner, who they perceived as a friendly suitor who had pledged to retain management and would continue Shorin and his family in an influential role"); *Netsmart*, 924 A.2d at 194 (noting that executives may have "an incentive to favor a particular bidder (or type of bidder)," especially if "some bidders might desire to retain existing management or to provide them with future incentives while others might not"); Goodwin v. Live Entm't Inc., No. Civ. A. 15765, 1999 WL 64265, at *19 (Del. Ch. Jan. 25, 1999) (noting that management was "likely to be retained, had discussed better contracts, and might obtain such contracts after the merger"); *see also In re* Atheros Commc'ns, Inc., C.A. No. 6124-VCN, 2011 WL 864928, at *11–12 (Del. Ch. Mar. 4, 2011) (requiring disclosure of the fact that CEO would be employed by a strategic acquirer); *In re* SS & C Techs. Inc. S'holders Litig., 911 A.2d 816, 820 (Del. Ch. 2006) (declining to approve disclosure-only settlement where the record supported an inference that the CEO "instigated this transaction through the use of corporate resources but without prior authorization from the board of directors. . . . in order to identify a transaction in which he could both realize a substantial cash payout for some of his shares and use his remaining shares and options to fund a sizeable investment in the resulting entity"). *In re* Prime Hosp., Inc., No. Civ. A. 652-A, 2005 WL 1138738, at *12 (Del. Ch. May 4, 2005) (refusing to approve settlement of stockholder litigation in part because of a CEO conflict of interest that made the compromised claims relatively strong)*; cf. In re* Pennaco Energy, Inc. S'holders Litig., 787 A.2d 691, 692–93 (Del. Ch. 2001) (noting that the target company's top officers bargained for increased severance compensation in anticipation of potential sale).

[119] *See Dollar Thrifty*, 14 A.3d at 597 ("The heightened scrutiny that applies in the *Revlon* (and *Unocal*) contexts are, in large measure, rooted in a concern that the board might harbor personal motivations in the sale context that differ from what is best for the corporation and its stockholders. Most traditionally, there is the danger that top corporate managers will resist a sale that might cost them their managerial posts, or prefer a sale to one industry rival rather than another for reasons having more to do with personal ego than with what is best for stockholders." (footnote omitted)); *Topps*, 926 A.2d at 64 ("When directors bias the process against one bidder and toward another not in a reasoned effort to maximize advantage for the stockholders, but to tilt the process toward the bidder more likely to continue current management, they commit a breach of fiduciary duty." (footnote omitted)).

[120] *In re* Rural Metro Corp. S'holders Litig., 88 A.3d 54, 90 (Del. Ch. 2014), *aff'd*, 129 A.3d 816 (Del. 2015).

populated with M&A experts. The company's board of directors accordingly needs outside help when another company proposes a merger or the company's managers themselves inquire into sales possibilities."[121]

Advisors, however, face conflicts of interest of their own. Delaware decisions have considered conflicts and complications arising out of a sell-side advisor's interest in offering buy-side financing,[122] a sell-side advisor's economic interest in the buyer,[123] a sell-side advisor's status as a creditor to the seller,[124] a sell-side advisor's contemporaneous representation of the buyer on another deal,[125] and a sell-side advisor's longstanding relationship with

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[121] William W. Bratton & Michael L. Wachter, *Bankers and Chancellors*, 93 TEX. L. REV. 1, 11–12 (2014) (citation omitted); *accord* Tuch, *supra* note 51, at 1088 ("Principals retain advisors because they themselves generally lack the expertise and experience to conceive, structure, and execute these deals . . . ."); William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055, 2061 (1990) (explaining that directors rely on advisors because directors frequently have "little or no experience in the sale of a public company").

[122] *See, e.g.*, *Rural Metro Corp.*, 88 A.3d 54 at 99–100 (finding a sell-side advisor aided and abetted board's breach of fiduciary duties where it failed to disclose efforts to act as buy-side financier); *In re* Del Monte Foods Co. S'Holders Litig., 25 A.3d 813, 833 (Del. Ch. 2011) (enjoining a merger where sell-side advisor "structured a small, private process that maximized the likelihood that it could provide acquisition financing"); Ortsman v. Green, C.A. No. 2670-N, 2007 WL 702475, at *1 (Del. Ch. Feb. 28, 2007) (ordering expedited discovery into board decision-making process where target's financial advisor participated in the buy-side financing even though company retained a separate financial advisor to render a fairness opinion); *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1005–1006 (Del. Ch. 2005) (examining sell-side advisor's "questionable desire to provide buy-side financing"); *see also* Bratton & Wachter, *supra* note 121, at 10 ("Bankers often have ties to acquiring companies and the parties financing their deals, leading to incentives to cater to the other side of the negotiating table."). *See* Alan D. Morrison & William J. Wilhelm, Jr., *Opacity, Trust, Reputation, and Law: The Evolution of Commitment in Investment Banking*, 7 J. LEGAL. ANALYSIS 363, 410 (2015) ("Stapled financing is the source of at least two conflicts. First, it discourages an advisor from seeking higher bids, because they serve to reduce the value of the security it takes when financing the deal. Second, it incentivizes the advisor bank to recommend bids by firms that are likely to use the stapled financing.").

[123] *See El Paso*, 41 A.3d at 440 (examining conflicts of interest where sell-side advisor owned 19% of bidder and controlled two of its board seats); *Solash v. Telex Corp.*, 1988 WL 3587, at *5, *10 (Del. Ch. Jan. 19, 1988) (considering implications for breach of fiduciary duty claims of sell-side financial advisor's ownership of 10% of acquirer).

[124] *See* Khanna v. McMinn, No. Civ. A. 20545-NC, 2006 WL 1388744, at *25 (Del. Ch. May 9, 2006) (finding plaintiffs had raised facts sufficient to "create a reasonable doubt that the transaction was the product of a valid exercise of business judgment" where investment bank provided a bridge loan to the seller to be repaid with the sale proceeds).

[125] Transcript of Telephone Conference at *11–12, *In re* PLX Tech. Inc. S'holders Litig., C.A. No. 9880-VCL, at 11–12 (Del. Ch. Sept. 3, 2015) (considering allegations that a sell-side advisor aided and abetted breaches of fiduciary duty by board where advisor had extensive

parties on the other side of the bargaining table.[126] An advisor may also "act with a view to obtaining or maintaining a lucrative advisory relationship with the managers of the merger's surviving company."[127]

Customary investment banker compensation arrangements can also influence the outcomes of sales processes.[128] For M&A transactions, investment bankers often enter into a contingent compensation arrangement that pays the banker a percentage of

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relationship with most likely bidder including contemporaneously representing it in another significant transaction, having received over $50 million dollars in fees from it over the last several years, and lending it significant sums of money).

[126] *See, e.g., In re* Dole Food Co., Inc. S'holder Litig., C.A. Nos. 8703-VCL, 9079-VCL, 2015 WL 5052214, at *2, *4 (Del. Ch. Aug. 27, 2015) (finding sell-side advisor "acted improperly by favoring Murdock [the bidder] and treating him as the bank's real client in transactions before the Merger" where it "had worked with Murdock for years" and was contemporaneously working with him on other engagements); Simonetti v. Margolis, C.A. No. 3694-VCN, 2008 WL 5048692, at *6–7 (Del. Ch. June 27, 2008) (issuing a preliminary injunction where target failed to disclose that its current advisor had advised the bidder in connection with a prior potential financing in the target and the bidder's advisor had advised the seller in connection with the same); *In re* Emerging Commc'n, Inc. S'holders Litig., Civ. A. 16415, 2004 WL 1305745, at *25, *32 (Del. Ch. May 3, 2004) (finding take-private was "unfairly structured" where CEO and purchaser "co-opted" company's long-term advisors that "possessed material nonpublic information about [the company's] values, business and prospects"); *see also In re* Prime Hospitality, Inc. S'Holders Litig., No. Civ. A. 652-N, 2005 WL 1138738, at *9–12 (Del. Ch. May 4, 2005) (declining to approve a settlement where sell-side advisor had a longstanding relationship with buyer that plaintiffs' counsel failed to explore); Braunschweiger v. Am. Home Shield Corp., C.A. No.10755, 1991 WL 3920, at *6 (Del. Ch. Jan. 7, 1991) (denying a motion for summary judgment where proxy failed to disclose that manager leading MBO was involved in retention of special committee's investment banker); *cf. Macmillan*, 559 A.2d at 1277 (granting targeted injunction on appeal against asset lock-up and no-shop clause where directors relied on advice from conflicted management's financial advisor).

[127] Bratton & Wachter, *supra* note 121, at 21 (citations omitted); *see, e.g., In re* John Q. Hammons Hotels Inc. S'holder Litig., Civ. Action No. 758-CC, 2009 WL 3165613, at *16 (Del. Ch. Oct. 2, 2009) (denying a motion to dismiss relating to a disclosure claim focusing on conflict of interest that banker faced "because it had contacts with [the buyer] about the possibility of underwriting the nearly $700 million commercial mortgage-backed security offering planned by [the buyer] after completion of the Merger").

[128] *See Rural Metro*, 88 A.3d at 90 (holding investment banker liable for aiding and abetting breach of fiduciary duty by board of directors where banker sought to maximize its own fees when structuring and conducting sale process); *In re* Cysive, Inc. S'holders Litig., 836 A.2d 531, 542 (Del. Ch. 2003) (noting that target's financial advisor "had an incentive to prefer a sale over a liquidation of the company because its fee agreement provided it with additional payments for a sale"); *Netsmart*, 924 A.2d at 199 (noting that for the target's financial advisor, "[t]he path of dealing with a discrete set of private equity players was attractive to its primary client contact—management—and the quickest (and lowest cost) route to a definitive sales agreement").

the deal's value if it closes.[129] Although a contingent fee arrangement generally will align the interests of the agent in getting more compensation with the principal's desire to obtain the best value,[130] the interests of the agent and principal diverge over whether to take the deal in the first place. "The agent only gets paid if the deal happens, but for the principal, the best value may be not doing the deal at all."[131] A similar dynamic plays out on a smaller scale during the final negotiations over price. "The contingently compensated agent has a greater incentive to get the deal done rather than push for the last quarter, particularly if pushing too hard might jeopardize the deal and if the terms on offer are already defensible."[132] Furthermore, many investment bankers are repeat players. Not only can they "generate greater aggregate compensation by completing more total transactions with slightly less compensation on each deal" but when "the opposite side in the negotiation is a repeat player that has used and could continue to

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[129] *See* Tuch, *supra* note 51, at 1097–1098 (discussing advisor fees).

[130] *See, e.g., In re* Atheros Commc'ns, Inc. S'holder Litig., C.A. No. 6124-VCN, 2011 WL 864928, at *8 (Del. Ch. Mar. 4, 2011) ("Contingent fees are undoubtedly routine; they reduce the target's expense if a deal is not completed; perhaps, they properly incentivize the financial advisor to focus on the appropriate outcome."); Van de Walle v. Unimation, Inc., Civ. A. No. 7046, 1991 WL 29303, at *3 (Del. Ch. Mar. 7, 1991) (noting that a contingent fee creates "an incentive to obtain the best available price for all . . . stockholders").

[131] *Rural Metro*, 88 A.3d at 94.

[132] *Id.* at 94 (finding that a board acted unreasonably for purposes of enhanced scrutiny analysis by failing to provide sufficient oversight to an investment banker during final negotiations over price); *see El Paso*, 41 A.3d at 442 (discussing how a $35-million-or-nothing contingent fee made "more questionable some of the tactical advice given by Morgan Stanley and some of its valuation advice, ..."); *Atheros*, 2011 WL 864928, at *8 (noting that a "contingent fee can readily be seen as providing an extraordinary incentive for [an investment bank] to support the Transaction"); Transcripts of the Rulings of the Court at 10, Forgo v. Health Grades, Inc., C.A. No. 5716–VCS, at 10 (Del. Ch. Sept. 3, 2010) ("[T]he reality is if [the investment bank] can get a deal, they get a deal."); *Netsmart*, 924 A.2d at 199 (noting that although an investment bank would receive 1.7% of any deal, it had "a strong incentive to bring about conditions that would facilitate a deal that would close"); *In re* Tele–Communications, Inc. S'holders Litig., No. Civ. A. 16470, 2005 WL 3642727, at *10 (Del. Ch. revised Jan. 10, 2006) ("[T]he contingent compensation of the financial advisor, DLJ, of roughly $40 million creates a serious issue of material fact, as to whether DLJ (and DLJ's legal counsel) could provide independent advice to the Special Committee."); *see also* City Capital Assocs. L.P. Ltd. P'ship v. Interco, Inc., 551 A.2d 787, 793 (Del. Ch. 1988) (Allen, C.) ("The board had agreed to a compensation arrangement with Wasserstein Perella that gives that firm substantial contingency pay if a restructuring is successfully completed. Thus, Wasserstein Perella has a rather straightforward and conventional conflict of interest when it opines that the inherently disputable value of its restructuring is greater than the all cash alternative offered by plaintiffs.").

use the agent's services, then the incentives to maintain goodwill and not push too hard become all the greater."[133]

As these examples indicate, "[i]nvestment bankers have ample opportunities for misconduct resulting from . . . the conflicts of interest afflicting the firms for which they work."[134] Some have observed that "conflict is inevitable in investment banking."[135] Importantly, the consequences of the contacts and relationships that can generate conflicts are not necessarily negative. "[T]he advisor's value stems in part from these very contacts, for the contacts are the sources of the information the advisor brings to the seller's table."[136] Put differently, "[c]onflicted bankers, if appropriately managed, can add value to a deal," but "conflicted bankers" who are "not appropriately managed, can be a destructive influence even given full disclosure and engagement of a second, unconflicted banker."[137]

What matters here is that the involvement of contingently compensated and potentially conflicted advisors heightens the complications created in the high-pressure, high-risk, and high-reward context of a third-party M&A event. As several commentators have now suggested, the overarching reality of decision-making context counsels in favor of applying enhanced

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[133] *Rural Metro*, 88 A.3d at 94 (footnote omitted); *see El Paso*, 41 A.3d at 444 (noting that a conflicted negotiator has a duty "to squeeze the last drop of the lemon out for . . . stockholders," but that the conflict gave the negotiator "a motive to keep juice in the lemon that he could use to make a financial Collins for himself . . . ."); *id.* ("[A] fist fight of a negotiation might leave a bloodied [adversary] unreceptive to a [future deal] . . . ."); Gesoff v. IIC Indus. Inc., 902 A.2d 1130, 1150–51 (Del. Ch. 2006) (holding that investment bank's relationship with buy-side controlling stockholder "robs [its] fairness opinion of its value as an indicator of fairness . . . ."); *cf. Lear*, 926 A.2d at 116 (noting that if a CEO received equity on the buy side post-merger, "the failure to get the [optimal] price for Lear now would not hurt him as much as the public stockholders . . . .").

[134] Andrew F. Tuch, *The Self-Regulation of Investment Bankers*, 83 GEO. WASH. L. REV. 101, 107 (2014).

[135] Alan D. Morrison & William J. Wilhelm Jr., *Trust, Reputation, and Law: The Evolution of Commitment in Investment Banking*, 7 J. LEGAL ANALYSIS 363, 407 (2015); *see also* Simonetti v. Margolis, C.A. No. 3694-VCN, 2008 WL 5048692, at *14 (Del. Ch. June 27, 2008) ("Perhaps it is unavoidable that financial advisors regularly seem to suffer from conflicts of one degree or another . . . .").

[136] Bratton & Wachter, *supra* note 121, at 21; *accord* Eric S. Klinger-Wilensky & Nathan P. Emeritz, *Financial Advisors' Engagement Letters: Post-*Rural/Metro *Thoughts and Observations*, 71 BUS. LAW. 53, 59 (2015) (discussing how conflict disclosure in engagement letters can "assist the board in . . . deciding whether to engage the financial advisor in spite of (or in many cases because of the benefits arising from) the potential conflict[s].").

[137] Bratton & Wachter, *supra* note 121, at 9.

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scrutiny to all sell-side M&A transactions, regardless of the form of consideration.[138] To date, the Delaware Supreme Court has not openly adopted the broader understanding of the potential conflicts presented by M&A scenarios that Chief Justice Strine articulated while serving as a member of the Court of Chancery.

The court has recognized, however, that enhanced scrutiny applies to a board's decision to include deal protection measures in a merger agreement, even if the merger agreement is a stock-for-stock transaction to which enhanced scrutiny would not otherwise apply under Delaware's current patchwork of precedent.[139] Enhanced scrutiny applies to these measures because "[t]here are

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[138] *See* Laster, *supra* note 7, at 35 ("[I]f potential conflicts drive enhanced scrutiny, then enhanced scrutiny should apply to negotiated acquisitions, regardless of the form of consideration"); Morgan White-Smith, *Revisiting* Revlon: *Should Judicial Scrutiny of Mergers Depend on the Method of Payment?*, 79 U. CHI. L. REV. 1177, 1206 (2012) (arguing for "[a] broad application of enhanced scrutiny to corporate acquisitions and mergers . . . ."); Black & Kraakman, *supra* note 76, at 536 (noting that stock-for-stock mergers "justify similar scrutiny"). *See generally* Lawrence A. Hamermesh, *Premiums in Stock-for-Stock Mergers and Some Consequences in the Law of Director Fiduciary Duties*, 152 U. PA. L. REV. 881, 886 (2003). Professor Stephen Bainbridge also has argued in favor of dispensing with the focus on consideration and instead focusing on conflicts, but with the different end point of eliminating cash deals involving a publicly-traded acquirer as a context where enhanced scrutiny applies. *See* Stephen M. Bainbridge, *The Geography of* Revlon-*Land,* 81 FORDHAM L. REV. 3277, 3335 (2013) ("[S]o long as acquisitions of publicly held corporations are conducted by other publicly held corporations, diversified shareholders will be indifferent as to the allocations of gains between the parties."). Critical to his assessment is the belief that problematic conflicts of interest do not warrant concern when the acquirer is a publicly-traded entity. Alternatively, he posits that any harm from the conflict washes out because diversified stockholders are likely to hold shares in both entities. *See id.* at 3331–33 (noting that in publicly traded entities owned by dispersed shareholders in the "large, fluid, changeable and changing market . . . . [t]he form of consideration is simply irrelevant"). The hypothesis that public company deals fail to create divergent interests for management and directors is, we believe, a stretch. The diversified stockholder rationale, by contrast, is a fair argument from the standpoint of societal efficiency, but it fails to reckon with the fiduciary nature of the Delaware law analysis, which concerns itself with the relationship between the corporate fiduciaries and the stockholders to whom those fiduciaries owe duties. But he does properly identify the weakness of the cash-versus-stock dichotomy that persists in Delaware law.

[139] *See Omnicare*, 818 A.2d at 931 ("[D]efensive devices . . . must withstand enhanced judicial scrutiny under the *Unocal* standard of review, even when that merger transaction does not result in a change of control." (footnote omitted)); *Time-Warner,* 571 A.2d at 1150–51 (rejecting application of enhanced scrutiny to merger under *Revlon* but holding that defensive measures in merger agreement are "properly subject to a *Unocal* analysis."); *accord* McMillan v. Intercargo Corp., 768 A.2d 492, 506 n.62 (Del. Ch. 2000) ("Under a 'duck' approach to the law, 'deal protection' terms self-evidently designed to deter and make more expensive alternative transactions would be considered defensive and reviewed under the [*Unocal*] standard."). *See generally* Strine, *supra* note 114, at 934 (arguing for *Unocal* review of defensive measures in stock-for-stock merger agreements).

inherent conflicts between a board's interest in protecting a merger transaction it has approved, the stockholders' statutory right to make the final decision to either approve or not approve a merger, and the board's continuing responsibility to effectively exercise its fiduciary duties at all times after the merger agreement is executed."[140] The Delaware Supreme Court has thus recognized that a sufficient conflict exists in these scenarios to warrant applying enhanced scrutiny, albeit only to portions of the merger agreement.

IV. The Fit Between Enhanced Scrutiny and Buy-Side M&A Decisions

From a theoretical standpoint, enhanced scrutiny seems like a strong fit for reviewing buy-side M&A decision-making. It is not a perfect fit. Nevertheless, from a doctrinal perspective, applying enhanced scrutiny to buy-side M&A decisions is a logical extension of the doctrine. This section will explain some of the supportive and countervailing considerations for applying enhanced scrutiny to a board's decision to buy a company.

A. Supportive Considerations

There are a number of reasons to extend enhanced scrutiny to buy-side M&A decisions. We expand on the three primary reasons below.

Most prominently, the core conflict-derived rationale for applying enhanced scrutiny on the sell-side applies equally on the buy-side M&A scenarios. As discussed in Part I, empirical studies show that buy-side M&A settings create potentially powerful incentives for senior managers that may cause their interests to diverge from those of the corporation and its stockholders as a whole.[141] This is especially true in public company acquisitions, where the potential for realization of the value of the transaction is uncertain, but the prestige and compensation connected with purchasing another public company is high. Enhanced scrutiny addresses precisely this risk.

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[140] *Omnicare*, 818 A.2d at 930.
[141] *See supra* Part II.A.

The sell-side concern that contingently compensated advisors may magnify the confounding incentives faced by senior managers applies to the buy-side as well. Like potential sellers, potential acquirers regularly hire investment bankers under contingency fee arrangements, which gives the bankers powerful financial incentives to pursue and close deals.[142] Unlike on the sell-side, where the acquisition of a client and the resulting disappearance of a source of business may mitigate the advisor's eagerness to support a sale, similar relationships on the buy-side reinforce the financial incentive. A longstanding advisor's personal relationship with management may give the advisor additional reason to support an acquisition that management favors, particularly if a successful acquisition may lead to a bigger company that will purchase more companies in the future.[143] Although legal advisors usually do not receive contingent compensation,[144] the same concerns about ongoing relationships and support for management's chosen path apply to legal advisors.

The real-world decision-making context in which boards operate also supports extending enhanced scrutiny to buy-side decisions. At present, there is reason to suspect that without a jurisprudential prod like enhanced scrutiny, directors may not be sufficiently involved in the buy-side acquisition process—just as they were less involved in the sell-side acquisition process before the systemic shock of *Van Gorkom*, *Revlon*, and other cases from the watershed year.[145] Descriptive accounts indicate that boards are reluctant to become deeply involved in acquisitions, preferring to leave the process in the hands of management and their advisors,[146] with the

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[142] *See supra* notes 120–137.

[143] Frankel, *supra* note 55, at 357–358.

[144] There are exceptions. *See* Richard W. Painter, *Irrationality and Cognitive Bias at a Closing in Arthur Solmssen's* The Comfort Letter, 69 FORDHAM L. REV. 1111, 1136 (2000) (describing examples of contingency fees in M&A work).

[145] *See supra* notes 71–76 and accompanying text. The jurisprudential prod may be an important tool for the further development of norms and best practices for buy-side boards in reviewing the recommendations of potentially conflicted managements and advisers. *See generally* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work*? 44 UCLA L. REV. 1009 (1997); Lymon Johnson, *Counter-Narrative in Corporate Law: Saints and Sinners, Apostles and Epistles*, 2009 MICH. ST. L. REV. 847 (2009).

[146] *See* Chinta Bhagat & Bill Huyett, *Modernizing the Board's Role in M&A*, MCKINSEY QUARTERLY (Feb. 2013), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/modernizing-the-boards-role-in-m-and-a ("Many boards, reluctant to cross the line between governance and management, miss opportunities to help

board restricting itself to an advisory and oversight roles.[147] Although the board theoretically retains ultimate approval authority, once management and its advisors begin to feel committed to a deal and have expended significant resources to move forward on a transaction, abandoning plans can be quite difficult.[148]

Extending enhanced scrutiny to buy-side decisions also recognizes another real-world aspect of the decision-making environment: boards often are not considering an acquisition in isolation but rather as part of an overall menu of strategic alternatives. Those alternatives frequently will include sell-side possibilities which trigger enhanced scrutiny under existing Delaware law, such as a sale for cash, a stock transaction, or recapitalization in which the corporation emerges with a controlling stockholder. Equally important, announcing an acquisition may have the unintended effect of putting a company in play, thereby generating a scenario in which enhanced scrutiny will apply from the sell-side perspective.[149]

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senior executives win at M&A."); *see also* Holly J. Gregory, *The Board's Role in M&A Transactions*, PRACTICAL L.J. 36 (May 2014) (encouraging greater board involvement in M&A).

[147] *See* Alexandra R. Lajoux, *Role of the Board in M&A*, HARV. L. SCH. F. ON CORP. & FIN. REG. (Sept. 7, 2015), https://corpgov.law.harvard.edu/2015/09/07/role-of-the-board-in-ma/; *see also* KPMG, *The Board's Perspectives on M&A: From Due Diligence to Day 1 and Beyond* 1 (2013), http://www.execed.kpmg.com/content/PDF/The-Boards-Perspective-on-MA.pdf ("About one in three of the directors surveyed say their board could be more involved in shaping M&A strategy and in evaluating deals proposed by management.").

[148] *See* Gregory, *supra* note 146 at 34–35 (noting the many considerations for potential deal activity and how management teams can develop strong views about courses of action).

[149] As Chief Justice Strine observed while serving on the Court of Chancery:

> It is no small thing for a strategic acquirer to come public about its desire to buy another industry player. Although management-side doctrinal junkies will cry that a board's interest in buying another industry competitor does not mean that the company would be well served by a similar transaction in which it is the seller—i.e., that the company is "in play"—the reality is that the announcement of interest in a strategic transaction does signal that some other business strategy rather than the status quo would, in the board's judgment, be optimal.

Dollar Thrifty, 14 A.3d at 603-04. Because a buy-side decision may lead to a sell-side M&A *scenario*, the conflicts raised by the latter lurk in the former, albeit one step removed. The risk that a buy-side decision may lead to a sell-side scenario reinforces the case for applying enhanced scrutiny to the original buy-side.

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Under present Delaware law, a lawyer attempting to guide directors through various possibilities would advise that the business judgment rule applies to some alternatives, while enhanced scrutiny applies to others. Extending enhanced scrutiny to the buy-side alternatives applies a consistent standard of review, thereby framing the inquiry in terms of the real-world question that directors typically ask: which of these alternatives is reasonably likely to provide the best risk-adjusted value for the stockholders?

B. COUNTERVAILING CONSIDERATIONS

Although there are good reasons to extend enhanced scrutiny to buy-side M&A decisions, the concept is not a perfect fit. This section describes four concerns to extending enhanced scrutiny to the buy-side.

For starters, extending enhanced scrutiny to acquisitions will not make sense to those who perceive enhanced scrutiny in the deal context as a special obligation to maximize immediate stockholder value. In part because of the implications of such a shift, this school of thought seeks to limit strictly the application of enhanced scrutiny to three categories of sell-side deal structures: (i) sales for cash, (ii) transactions resulting in a change of control, and (iii) transactions leading to the break-up of the company.[150] For those who resist expanding enhanced scrutiny beyond these categories, extending it to the buy-side would be anathema. Nevertheless, as we highlighted above, we disagree with this narrow reading of the enhanced scrutiny doctrine.[151]

Even if one accepts that the impetus for enhanced scrutiny arises from situational conflicts, there is reason to think that the level of potential conflict on the buy-side may not be as pronounced as on the sell-side, or at least is subject to greater regulation by market forces. Commentators have argued that actual and potential

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[150] *See* Bainbridge, *The Geography of* Revlon-*land*, *supra* note 138, at 3331–32 (describing the three categories). This approach relies heavily on two Chancery Court cases. *See In re* Santa Fe Corp. S'holder Litig., 669 A.2d 59, 71 (Del. 1995); Arnold v. Society for Sav. Bancorp., Inc., 650 A.2d 1270, 1290 (Del. 1994).

[151] *See supra* Part III.B.

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conflicts of interest arise in sell-side situations because of the final period problem.[152]

> [I]n a situation where parties expect to have repeated transactions, the recognition that a party who cheats in one transaction will be penalized by the other party in subsequent transactions reduces the incentive to cheat. However, when a transaction is the last (or only) in a series—that is, the final period—the incentive to cheat reappears because, by definition, the penalty for doing so has disappeared.[153]

In the ordinary course of business, the ability of managers to shirk or self-deal is constrained not only by legal duties but also by a range of markets, including the product markets, capital markets, employment markets, and the market for corporate control.[154] These markets react to board and managerial actions and penalize decisions inconsistent with corporate interests. But when managers

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[152] *See* Bainbridge, *supra* note 60, at 788–89 (discussing the final period problem); *accord* Stephen M. Bainbridge, *The Story of* Smith v. Van Gorkom, *in* CORPORATE LAW STORIES 197, 223 (J. Mark Ramseyer, ed., 2009) ("Corporate acquisitions are a classic example of what game theories refer to as 'final period problems.'") [hereinafter *Story of* Van Gorkom]; Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 FORDHAM L. REV. 1899, 1945 (2003) ("Although the drama and hyperbole of a bust up acquisition is typically not present in the context of a 'friendly' merger—after all, the business continues to operate and many employees keep their jobs—last period features are still present at the level of the board of directors and senior management, many of whom are likely to be in the last period of their employment."); Black & Kraakman, *supra* note 76, at 536 (describing negotiated acquisition as a scenario in which "the target's managers and board will likely lose their positions. They face a strong conflict of interest, yet they are in a final period where reputation and fear of future discipline lose their force as constraints on self-interested behavior."); Ronald J. Gilson & Reinier Kraakman, *What Triggers* Revlon*?*, 25 WAKE FOREST L. Rev. 37, 54 (1990) ("A friendly merger in which the ownership of a constituent company remains diffuse but de facto control shifts from one management team to another, is no less a control shift than a transaction that gives rise to a control block . . . . [T]he absence of [a controller] . . . does not reduce the danger that [stockholder] interests will suffer under the merger terms negotiated by their own management.").

[153] RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 720 (2d ed. 1995).

[154] *See* Bainbridge, *supra* note 60, at 785 ("Corporate directors operate within a pervasive web of accountability mechanisms that substitute for monitoring by residual claimants. A variety of market forces provide important constraints. The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by firm agents.").

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are in their final period, market constraints have less bite, and managers are more likely to favor their own interests or self-deal.[155]

Significant acquisitions can give rise to final period problems, particularly if the transaction threatens job losses for buy-side fiduciaries. Unlike sell-side transactions, however, the buy-side entity continues. Other markets should penalize poor buy-side acquisitions, providing additional checks on buy-side decision making. If the acquirer has overpaid, then the stock market should punish its shares, and the fewer resources that it has available for other corporate purposes should undercut its ability to compete more broadly.[156] In theory, buy-side fiduciaries should take these risks into account, and they should mitigate buy-side conflicts to a better extent than on the sell-side.

Buy-side M&A situations also differ from sell-side scenarios in that not all transactions involve potentially transformational or significant outcomes for the acquirer. The best example is when a large entity buys a much smaller one—colloquially described as the whale swallowing the minnow. On the sell-side, the separate business identity of the minnow is likely to disappear, both in the strict legal sense of a merger and in the larger metaphorical sense. On the buy-side, this need not be true. A large business could buy a small business without the transaction having meaningful effect on its corporate culture or personnel, and the empirical evidence indicates that there is less reason for concern about these types of acquisitions.[157] This suggests that the application of enhanced scrutiny to buy-side M&A scenarios could require greater flexibility in the application of the doctrine and potentially more nuanced line-drawing.[158]

Perhaps the strongest reason to question whether enhanced scrutiny should apply to buy-side decisions is the doctrine's mixed

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[155] *Id.* at 788.

[156] For a discussion of why the right to sell many not sufficiently discipline managers of the acquirer, *see* Afsharipour, *Voting Rights*, supra note 1, at 142-144.

[157] *See supra* notes 34–38 and accompanying text.

[158] This article does not address where the line should be drawn, leaving that area open for future work. Nevertheless, there are existing sources of authority that could prove helpful, such as situations where positive law already requires buy-side votes. These sources include (i) a largely moribund voting requirement for direct mergers under Delaware law involving the issuance of 20% or more of the acquirer's stock and (ii) listing standards that have created a taxonomy of transactions warranting stockholder votes.

record in addressing sell-side conflicts. There is little reason to think that the track record for buy-side decisions would be better, and at least one reason to think it would be worse.

One recurring criticism of enhanced scrutiny on the sell-side is that it evolved into a relatively toothless test. In the more than four decades since the introduction of the intermediate standard of review, courts have rarely held that sell-side fiduciaries breached their fiduciary duties under enhanced scrutiny. Just one decision (the implicit application of enhanced scrutiny in *Van Gorkom*) held directors liable for breaching their duties.[159] One other decision (*RBC Capital Markets*) held that an investment banker was liable for aiding and abetting directors in breaching their fiduciary duties.[160] A handful of decisions resulted in the issuance of preliminary injunctions against particular transaction features.[161] Another handful of cases held under the injunction standard that a plaintiff had shown a reasonable probability of proving at trial that the directors had breached their duties under the enhanced scrutiny standard, but deferred to stockholders to accept or vote down the transaction, at times with the benefit of additional disclosures regarding the deal process and the subtle conflicts that played a role in generating the deal.[162] Some enhanced scrutiny cases have

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[159] 488 A.2d 858.

[160] 129 A.3d 816, 849 (Del. 2015).

[161] *See QVC*, 738 A.2d at 51 (affirming injunction against no-shop provision and stock-option lockup and extending injunction to include termination fee); *Macmillan*, 59 A.2d at 1285-86, 1288 (affirming injunction against waiver of rights plan and expanding injunction to include crown-jewel asset lockup and no-shop clause); *Revlon*, 506 A.2d at 184-85 (issuing targeted preliminary injunction against crown-jewel asset lockup, no-shop clause, and provision waiving rights plan to allow existing deal to proceed); *Del Monte*, 25 A.3d at 840-43 (granting conditional injunction against transaction subject to injunction lifting if parties conducted a twenty-day post-signing process); *Topps*, 926 A.2d at 87–91 (granting conditional injunction against transaction subject to injunction lifting if target board waived standstill provision for topping bidder). In *Omnicare*, the Delaware Supreme Court reversed the Court of Chancery's denial of a preliminary injunction, but rather than issuing a targeted preliminary injunction or directing the trial court to issue one, the high court held that the challenged provisions were "invalid and unenforceable." 818 A.2d at 937.

[162] *See, e.g., El Paso*, 41 A.3d at 434 (finding reasonable likelihood of success on merits but denying preliminary injunction where "the stockholders of El Paso, as the seller, have a choice whether to turn down the Merger themselves"); *Netsmart*, 924 A.2d at 208 (finding reasonable likelihood of success on the merits, but denying preliminary injunction; noting that "when a potential *Revlon* violation occurred but no rival bid is on the table, the denial of injunctive relief is often premised on the imprudence of having the court enjoin the only deal on the table, when the stockholders can make that decision for themselves." (footnote omitted)).

settled for significant monetary payments, but these settlements are rare.[163]

Many factors likely contributed to the lack of rulings finding that sell-side directors breached their duties under the enhanced scrutiny standard of review. One important factor is the complexity of the decisions that directors face. Evaluating competing alternatives and deciding to sell a corporation are judgment-laden endeavors. Even when weighing an all-cash transaction, directors must consider issues like the likelihood of closure, the timing of payment, and tax effects.[164] In a stock deal, because the consideration includes an ownership interest in an ongoing entity, the directors are entitled to consider how that entity will generate value over the long-term. The board may attribute value to the synergies that would be created by combining the two companies. The board may anticipate that the combined company could be sold at some point in the future.

Any or all of these factors could lead the directors to conclude that the share of the entity their corporation's pre-transaction stockholders would own post-combination represents the best alternative available.[165] When directors have worked through complex issues with the assistance of advisors, it is exceedingly difficult for a court to reach a different outcome, even when there is some evidence of divergent interests or personal advantage. Similar complexities await the judiciary in reviewing buy-side decisions under enhanced scrutiny. There is no reason to think that courts will be better at evaluating whether buy-side decisions fall within a range of reasonableness, or will be more willing to involve themselves in debatable matters.

A perhaps more significant criticism of sell-side enhanced scrutiny doctrine is that it evolved into a vehicle for rent-extraction

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[163] *See* Joel Edan Friedlander, *Vindicating the Duty of Loyalty: Using Data Points of Successful Stockholder Litigation as a Tool for Reform*, 72 BUS. LAW. 623, 627–29 (2017) (identifying six M&A litigation settlements that generated significant monetary recoveries, in addition to the post-trial ruling in *Rural-Metro* and a settlement of claims challenging a restructuring in *Activision*).

[164] *See, e.g.*, *Dollar Thrifty*, 14 A.3d at 578 (noting that when evaluating competing bids, the target board appropriately considered relative antitrust risk and contractual provisions addressing regulatory issues, indicating that "[v]alue is not value if it is not ultimately paid").

[165] *See QVC*, 637 A.2d at 44, 44 n.14 (outlining how a board should work through sell-side decisions).

by specialized plaintiffs' law firms. Plaintiffs' lawyers quickly recognized that they could plead claims for breach of duty under enhanced scrutiny with relative ease. The doctrine of enhanced scrutiny was designed to be sensitive to the possibility of disloyalty under ambiguous circumstances, and it therefore adopted pro-plaintiff features like the reasonableness standard and the placing of the burden of proof on the defendants.[166] These litigation features made enhanced scrutiny meaningful, but they also made it difficult for the defendants and trial courts to dispose of weak cases. The Delaware Supreme Court effectively endorsed the bringing of weak cases when it declined to dismiss a post-closing challenge to defensive measures in a third-party merger agreement, stating, "[t]his case may very well illustrate the difficulty of expeditiously dispensing with claims seeking enhanced judicial scrutiny at the pleading stage where the complaint is not completely conclusory."[167]

Slowly at first, and then at an accelerating place, the volume of stockholder-led, sell-side M&A litigation increased.[168] During the first decade of the 21st century, it became an epidemic, with sell-side challenges to over 90% of all takeovers in excess of $100 million.[169] This was an obvious red flag, because if there was good reason to think that over 90% of all takeovers had deep fiduciary problems, then some type of systemic intervention was needed.

More telling, the avalanche of lawsuits produced comparably minimal value for stockholders. The vast majority of cases were resolved through disclosure-only settlements, in which the defendants agreed to make supplemental disclosures to stockholders in advance of the vote on the merger, and the merger parties and their directors, officers, affiliates, and advisors received a court-approved global release of known and unknown claims.[170]

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[166] *In re* Santa Fe Pacific Corp. S'holder Litig., 669 A.2d 59, 72 (Del. 1995).

[167] *Id.*

[168] *See* Matthew D. Cain & Steven Davidoff Solomon, *A Great Game: The Dynamics of State Competition and Litigation*, 100 IOWA L. REV. 465, 475 tbl.I, 476 tbl.II (2015) (documenting the increase in merger litigation overall and the number of suits filed in connection with each individual transaction).

[169] Olga Koumrian, *Shareholder Litigation Involving Acquisitions of Public Companies: Review of 2014 M&A Litigation*, CORNERSTONE RESEARCH 1, 1 fig.1 (2015).

[170] *See* Joel Edan Friedlander, *How* Rural/Metro *Exposed the Systemic Problem of Disclosure Settlements*, 40 DEL. J. CORP. L. 877, 877 (2016) ("[A] generation of routine disclosure settlements undermined in various respects the proper functioning of a system for the judicial enforcement of fiduciary duties"); Jill E. Fisch, Sean J. Griffith & Steven Davidoff

As compensation for providing the ostensible benefits conferred by the settlement, the plaintiffs' attorneys received an award of attorney's fees, which for many years clustered in the mid- to high-six figures.[171] The attractiveness of the disclosure-only settlement to both defendants' and plaintiffs' lawyers channeled virtually all M&A cases into the same non-substantive result.[172]

There is no reason to think that applying enhanced scrutiny to buy-side acquisitions would be more successful doctrinally than it has been on the sell-side. Sadly, the most likely result, if history is a guide, would not be to improve the quality of buy-side decisions, but rather open up a new avenue for rent-extraction by stockholder plaintiffs' firms. While some plaintiffs' law firms sued the sell-side directors for breaching their fiduciary duties when selling the firm, others would sue the buy-side directors for breaching their fiduciary duties when buying the firm. Expanding the application of enhanced scrutiny would double the litigation opportunities. At present, there is no reason to believe that the additional litigation would generate benefits that would outweigh its costs.

V. A PATH TO BUY-SIDE STOCKHOLDER VOTING

Partly because of the failure of the stockholder-led M&A litigation project, the Delaware courts have been re-tooling litigation standards to reduce, rather than expand, the ability of the plaintiffs' bar to bring litigation and extract settlements. One major

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Solomon, *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 TEX. L. REV. 557, 559 (2015) (arguing that there is "widespread skepticism" concerning the value of deal litigation because, in "most settled cases, the only relief provided to shareholders consists of supplemental disclosures in the merger proxy statement"); *see also In re* Trulia Inc. S'holder Litig., 129 A.3d 884, 891–99 (Del. Ch. 2016) (describing features of disclosure-only settlements and their problems).

[171] *See* Friedlander, *supra* note 170, at 878 (discussing fees awarded for disclosure settlements); Fisch, Griffith & Solomon, *supra* note 170, at 558–59 (same); Cain & Solomon, *supra* note 168, at 478–79 (same).

[172] There were exceptions to the general rule, and some stockholder litigation generated meaningful results. *See* Friedlander, *supra* note 163, at 627–28 (collecting cases). The stockholder plaintiffs' bar largely bifurcated into two groups: "One tier of law firms pursued disclosure settlements as a business model" and "[a]nother tier of law firms never presented disclosure settlements to the Court of Chancery, and instead brought *Revlon* cases with the objective of seeking a significant monetary recovery [or] significant non-monetary relief." Friedlander, *supra* note 170, at 904–05. While some plaintiffs' firms engaged in meaningful litigation activity and achieved monetary recoveries for investors, they were comparatively rare. *Id.*

development has been to hold that a fully informed stockholder vote on a merger lowers the standard of review applicable to a third-party M&A situation from enhanced scrutiny to the business judgment rule.[173] If enhanced scrutiny were extended to buy-side decisions, a likely countermove by transaction planners would be to condition more buy-side deals on favorable stockholder votes, thereby restoring the application of the business judgment rule. Indeed, one argument in favor of extending enhanced scrutiny to buy-side decisions rests not on the ability of the litigation itself to generate superior outcomes, but rather as an inducement to more frequent buy-side votes that would enable stockholders to guard against bidder overpayment.

Just as empirical studies provide evidence for the problem of bidder overpayment,[174] they likewise provide an entry point for understanding the potential benefits of buy-side voting. A study from 2008 found that "acquisitions without acquirer shareholder approval are associated with lower synergistic gains, both in percentage and dollar values."[175] The same study presented evidence that "deals without shareholder voting rights are associated with worse post-merger stock or operating performance than those with voting rights," which "indicates that the requirements of shareholder voting help deter management from pursuing mergers that are not favored by shareholders."[176] That said, a working paper from 2006 found little evidence of the value of bidder shareholder voting.[177]

More recently, a study from 2017 examined the effect of a buy-side vote using a hand-collected sample of U.S. transactions

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[173] *See, e.g.,* Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 308–09 (Del. 2015) (holding that a fully informed stockholder vote restores the business judgment rule as the standard of review, with a claim for waste as the only remaining challenge).

[174] *See supra* Part II.A.

[175] Jim Hsieh & Qinghai Wang, Shareholder Voting Rights in Mergers and Acquisitions 5 (Mar. 2008) (unpublished manuscript), https://pdfs.semanticscholar.org/f987/e479c7f5a36f20f0b0835757bcff01de223d.pdf.

[176] *Id.*

[177] Ehud Kamar, *Does Shareholder Voting on Acquisitions Matter?* 2, 4–5 (Am. Law & Econ. Ass'n Annual Meetings, Working Paper No. 64, 2006), http://law.bepress.com/cgi/viewcontent.cgi?article=1799&context=alea.

between 1995-2015.[178] The study found that in deals without buy-side votes, acquirer announcement returns were 3% lower than for deals requiring votes.[179] The authors observe that "[g]iven that the average acquirer has a market capitalization of $3.2 billion in our vote avoidance sample, a 3.0% difference in merger announcement returns corresponds to a value reduction of over $96 million, an economically significant amount to acquirer shareholders."[180] Moreover, the study found that bidders attempted to accumulate cash, and issue more equity, in the year prior to the deal in order avoid a shareholder vote in an acquisition.[181] The study also found "a large and significant jump in acquirer announcement returns at the 20% threshold in all-stock deals when shareholder voting is mandatory," an effect that is concentrated among acquirers with high institutional ownership.[182] The authors infer from these results that "the prospect of a shareholder vote serves as a disciplinary device that makes acquirer management choose targets with greater synergies and/or offer lower premiums than in cases without shareholder voting."[183]

Another study from 2017, however, examined the effects of the NASDAQ's adoption of a listing requirement in 1989 that required a stockholder vote when the bidder issues 20% or more of its stock.[184] Based on the performance of acquisitions following the enactment of the rule, they found little evidence that shareholder voting provides benefits to bidder shareholders.[185]

Conducting empirical studies of U.S. acquisition is difficult because under U.S. corporate law rules and listing standards, the parties to an acquisition can structure the deal to avoid a buy-side

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[178] *See* Kai Li et al., *Vote Avoidance and Shareholder Voting in Mergers and Acquisitions* 2 (European Corp. Governance Inst., Working Paper No. 481, 2016), https://ssrn.com/abstract=2801580 (discussing the study of buy-side voting).

[179] *Id.*

[180] *Id.*

[181] *Id.*

[182] *Id.* at 30.

[183] *Id.* at 3.

[184] Paul Mason et al., *Does Shareholder Voting Matter? Evidence From the Takeover Market*, 53 WAKE FOREST L. REV. 157 (2018).

[185] *See id.* at 163 (finding that the study's "results are consistent with concerns that the costs associated with these rules outweigh the benefits").

vote, creating endogeneity problems.[186] The strongest support for buy-side voting comes from a study published in 2016 that examines acquisitions in the U.K.[187] Unlike in the U.S., shareholder voting for large acquisitions in the U.K. is both mandatory and binding.[188] Listing Rule 10 of the United Kingdom Financial Conduct Authority requires prior approval from shareholders of the acquirer for transactions that are large relative to the acquirer, using several tests to measure relative size (Class 1 transactions).[189] A deal that equals or exceeds a 25% relative-size threshold under any one of the tests is a Class 1 transaction that requires a buy-side vote.[190] A deal that does not meet the 25% relative-size threshold under any of the tests is a Class 2 transaction that does not require a buy-side vote.[191]

The 2016 study examined Class 1 and Class 2 deals during an 18-year period from 1992 until 2010.[192] The study found that for Class 1 deals, shareholders gained $13.6 billion in the aggregate over the study period.[193] For Class 2 deals, shareholders lost $3 billion in the aggregate over the study period.[194] The authors argue that mandatory buy-side voting makes bidder management more likely to refrain from overpaying or proposing deals that are not in the interest of shareholders.[195] Noting that shareholders have never voted down a Class 1 acquisition, the authors infer the mandatory voting mechanism works as a credible threat against bad corporate acquisitions up front, and deals that were poorly received by the

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[186] *See* Afsharipour, *Voting Rights*, *supra* note 1, at 148 (noting that "management can choose to structure its acquisition to avoid a vote by bidder shareholders").

[187] *See* Becht et al., *supra* note 25, at 3037

[188] *See id.* ("We study the U.K. setting, where the listing authority has devised a system that is close to ideal because shareholder voting on large acquisitions is mandatory, binding, and imposed via a series of threshold tests.").

[189] U.K. FIN. CONDUCT AUTH., FINANCIAL CONDUCT AUTHORITY HANDBOOK Listing Rule 10 (2018), https://www.handbook.fca.org.uk/handbook/LR/10.pdf [hereinafter FCA HANDBOOK].

[190] *Id.* at Listing Rule 10.2.2, 10.5; *see* Becht et al., *supra* note 25, at 3041–43 (describing U.K. Listing Rules). A class 1 transaction refers to a transaction that amounts to 25% or more of any of the acquirer's gross assets, profits, or gross capital, or in which the consideration is 25% or more of the market capitalization of the acquirer's common stock. FCA HANDBOOK, *supra* note 189, at Listing Rule 10.2.2.

[191] FCA HANDBOOK, *supra* note 189, at Listing Rule 10.2.2; Becht et al., *supra* note 25, at 3037.

[192] Becht et al., *supra* note 25, at 3037.

[193] *Id.* at 3035, 3050.

[194] *Id.*

[195] *Id.* at 3061 ("[T]he available data does point to a deterrence effect of mandatory shareholder voting that makes CEOs and boards more likely to refrain from overpaying.").

market at announcement were often withdrawn prior to the shareholder vote.[196]

Taken together, the empirical research indicates that there are real benefits to buy-side votes on acquisitions. But those benefits are not free. Voting is costly. For a public company, the tangible costs include preparing and disseminating a proxy statement, soliciting and collecting proxies, holding a meeting of stockholders, and tabulating votes.[197] The need to hold a vote also creates intangible costs in the form of transactional uncertainty and deal risk. Shareholders may not make an informed decision, especially if shareholders are rationally apathetic, suffer from collective action problems, or have agency conflicts of their own.

The tangible costs are, of course, real, but acquirers already manage these costs in transactions that currently require buy-side stockholder votes under listing standards.[198] To mitigate costs, parties to the transaction often create a single, joint disclosure document. Advances in technology also mitigate costs, with electronic voting and virtual stockholder meetings easing these aspects of the process.[199] The impact of these costs is lessened under a system where buy-side votes are not mandatory, but rather optional as a means of lowering the buy-side standard of review from enhanced scrutiny to the business judgment rule.

Whether the intangible costs of transactional uncertainty are, in fact, costs depends on one's sense of both the underlying problem of bidder overpayment and the ability of buy-side voting to provide a solution. The possibility that buy-side stockholders may vote down a transaction is what provides the check on the overpayment

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[196] *See id.* at 3063 (explaining results indicate "mandatory shareholder voting generates substantial value improvements for acquirer shareholders").

[197] *See* Stuart H. Gelfond & Burcin Eren, *The NYSE's Complex Shareholder Approval Rules: Issuing New Securities? Do You Need Shareholder Approval?*, LEXIS PRAC. ADVISOR J., Sept. 2016 (noting the "extra time and expense that may come with the shareholder approval process").

[198] *See id.* ("The New York Stock Exchange . . . has specific requirements applicable to listed companies to receive shareholder approval in connection with certain transactions, including issuing equity and convertible securities, which are in addition to any applicable requirements under state law and SEC rules.").

[199] *See* Gretchen Morgenson, *Meet the Shareholders? Not at These Shareholder Meetings,* N.Y. Times (March 31, 2017), https://www.nytimes.com/2017/03/31/business/corporate-virtual-shareholder-meetings.html (discussing the "increasingly common corporate practice of holding annual meetings that offer only online participation for shareholders").

problem. Hence, to the extent that stockholders vote based on their beliefs about what maximizes firm value, the "bug" of deal risk is actually a "feature." That said, it is possible that sophisticated market players may structure their holdings to extract individualized benefits from deal outcomes, then act to achieve those outcomes to the detriment of the parties to the transaction and other market participants.[200] That problem, when it arises, can be addressed directly with targeted remedies. [201]

VI. CONCLUSION

Empirical evidence suggests that large public company acquisitions often destroy significant value for the acquiring firm. The bidder overpayment phenomenon has been consistently tied to managerial agency costs and behavioral biases. Corporate law should take into account and address the behavior of fiduciaries in making acquisition decisions. One way to determine whether directors and officers are fulfilling their duty of loyalty in M&A transactions is to subject these decisions to enhanced scrutiny. With respect to sell-side decisions, the Delaware courts have developed a conflict-derived rationale for applying enhanced scrutiny to decisions of fiduciaries. This Article argues that this rationale applies equally on the buy-side. Litigation is not without costs, and the experience of litigation on the sell-side has been less than ideal. To address the shortcomings of the current litigation regime, the Delaware courts have encouraged the use of a fully informed stockholder vote on the sell-side. This Article argues that one of the primary benefits of extending enhanced scrutiny to the buy-side is to induce bidders to seek a stockholder vote to mitigate the soft conflicts that feed into bidder overpayment.

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[200] *See,* Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 131 (2009) (discussing "empty voting," where "investors have retained voting rights without the financial risk attendant to the shares, allowing them to influence a particular vote to the possible detriment of the corporation as a whole"); *cf.* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 888 (2006) ("One way to address empty voting is to limit the voting rights of shareholders who hold greater voting than economic ownership.").

[201] *See, e.g.*, Crown EMAK Partners, LLC v. Kurz, 992 A.2d 377, 387–90 (Del. 2010) (discussing cause of action and remedies for vote-buying).

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