DIRECTOR PRIMACY AND *OMNICARE*

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I. INTRODUCTION

What a mess. The Delaware Supreme Court – the nation's top business law court – recently issued what has been called the most important corporate law decision in a generation.[1] It is surely one of the most puzzling, and provoked a rare dissent[2] within the famously unanimous Court. In *Omnicare v. NCS Healthcare*[3], the Court invalidated a number of "deal protection" measures[4] that the board of directors of a selling/target

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[1]David Marcus, *Disney's Dudley Do-Wrong*, The Daily Deal, June 16, 2003.

[2] David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 129 (1997) ("Even on deeply controversial issues, such as those that arose during the takeover wave of the 1980s, Delaware's justices almost invariably speak with a single voice.")

[3] 818 A.2d 914 (Del. 2003).

[4]To understand "deal protection measures" one needs to understand how the acquisition process typically works. After an acquisition agreement is signed between a buying company and selling company there is usually a period of time prior the close of the acquisition and a number of conditions precedent to closing. Among other things, shareholder approval of the selling company is usually required. Lots of things can happen between the time the deal is signed and the closing date. Most importantly for purposes of this Article, a rival buyer may emerge and try to acquire the seller by offering a higher price than the first buyer. If this occurs prior to the vote of the selling company's shareholders, then those shareholders are likely to reject the first buyer's proposal in favor of the second buyer's proposal. The first buyer wants to prevent this from happening since it has often spent considerable time and effort to locate the seller and negotiate a merger agreement. The first buyer therefore often demands that "deal protection measures" be included in the acquisition agreement. A deal protection measure includes any number of various types of provisions that make it less likely that a second buyer will emerge to acquire the seller and/or compensate the first buyer if it loses the deal to a rival buyer. One example is a "no shop" provision; such a provision restricts the seller's ability to solicit or negotiate with rival bidders. Another example is a termination fee, which requires the seller to pay the first buyer a sum of money if the

corporation agreed to in a merger agreement. There will undoubtedly be much justified criticism of this problematic case.[5] This Article, however, takes a different approach. While identifying and explaining many of *Omnicare*'s weaknesses, it attempts to make sense of what the Court did in the case.

And that is no small task. Among other things, the Court applied *Unocal*[6] "enhanced scrutiny" to deal protection measures even though the *Omnicare* negotiated acquisition did not satisfy the two traditional triggers for such "enhanced scrutiny" since it was not a response to a hostile takeover and did not result in a breakup, sale or change of control of the company.[7] After deciding to apply "enhanced scrutiny" the Court invalidated the deal protection measures because they supposedly "coerced" the target company's shareholders into accepting the target board's proposed merger as a *fait accompli*. But closer examination reveals that nobody was "coerced" into anything. In fact, shareholders controlling a majority of the votes specifically agreed to the deal protection measures and all the other shareholders were free to vote as they wished.

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seller's shareholders reject its merger agreement with seller. The deal protection provisions in *Omnicare* are explained *infra* at notes 92 through 105 and accompanying text. A seller will often agree to deal protection measures if it can extract a similarly valuable concession from the buyer or if it is concerned that the buyer will refuse to enter into an agreement without such measures. For an analysis and description of deal protection measures *see, e.g.,* Wayne O. Hanewicz, *When Silence is Golden: Why the Business Judgment Rule Should Apply to No-Shops in Stock-for-Stock Merger Agreements*, 28 J. OF CORP. L. 206 (2003); Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-Ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239 (1990).

[5] *See infra* notes 265 through 285 and accompanying text.

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

[7] *Id.* (enhanced scrutiny of takeover defenses); *see also* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985) (enhanced scrutiny of sales, break ups or changes in control). A stock-for-stock merger, like the one in *Omnicare*, is not considered a break up, sale or change of control. *See* Paramount v. Time, 571 A.2d 1140 (Del. 1989).

Finally, in addition to invalidating the deal protection measures using "enhanced" scrutiny, the Court strangely decided to invalidate them on the separate and independent ground that they were "invalid as they operate in this case." The Court's justification was that the deal protection measures caused the board to violate its fiduciary duties. Yet the Court never adequately explained its basis for concluding there was a breach of fiduciary duty. The Court simply proclaimed it.

In the course of trying to make sense of *Omnicare*, this Article will also evaluate the "director primacy" model of corporate governance that Professor Stephen Bainbridge has advocated for in a series of recent articles.[8] Director primacy is (for the most part) descriptively accurate and offers a compelling normative justification for why the board – and not the shareholders or the courts – should be the institution that gets to decide what a corporation does. Director primacy views the board as a "Platonic guardian" with "essentially nonreviewable" decisionmaking authority.[9] Although director primacy places some limits on director authority, these limits are derived solely from the need for the board to be held "accountable" for the shareholder wealth maximization norm and from balancing this need for accountability with the benefits of granting the board wide-

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[8] Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Northwestern L. Rev. 547 (2003) (hereinafter *Means and Ends*); Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 Stan. L. Rev. 791 (2002) (hereinafter *Takeovers*); Stephen M. Bainbridge, *Director v. Shareholder Primacy in the Convergence Debate*, 16 TRANSNAT'L LAW 45 (Fall 2002) (hereinafter *Convergence Debate*); Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts (*hereinafter *Nexus of Contracts)*, 88 IOWA L. REV. 1 (2002).
[9]Bainbridge, *Hostile Takeovers*, *supra* note 8, at 795, 807 (stating that "the board of directors . . . is a sort of Platonic guardian . . ." and that that the board has "essentially nonreviewable decisionmaking authority.").

ranging authority.[10] Further, Bainbridge explicitly disclaims that this balancing should shift decisionmaking authority from the board to some other institution (e.g., shareholders, courts).[11] As I explain below,[12] there is much to like about director primacy, including its justification for vesting decisionmaking authority in the board. Further, I agree that the board, in the great majority of cases, is and ought to be the paramount corporate decisionmaker. This Article, however, analyzes a weakness in the model. The weakness is that director primacy focuses too heavily on the board as the sole corporate decisionmaker. As a result, director primacy overlooks the infrequent, but nonetheless important, times at which the board is divested of decisionmaking authority and it is instead vested in other institutions, such as the courts or the shareholders.

This brings us to the reason why I have coupled my analysis of *Omnicare* with my critique of director primacy. Both my analysis and critique are based on the same fundamental premise, namely, that the function of corporate law is to allocate decisionmaking authority among various institutions, such as the courts, the shareholders and – of course – the board.[13] Put differently, the function of corporate legal rules is to decide who decides.

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[10]Bainbridge, *Takeovers*, supra note 8, at 805-90.
[11] *See infra* notes 153 through 155 and accompanying text.
[12] *See infra* notes 52 through 53 and accompanying text.
[13]Professor Neil Komesar has long argued that the function of legal rules is to allocate decisionmaking authority. *See, e.g.,* NEIL K. KOMESAR, LAWS LIMITS: THE RULE OF LAW AND THE SUPPLY AND DEMAND OF RIGHTS (2001); NEIL K. KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY (1994). My argument about the function of corporate legal rules draws directly from the insights of Professor Komesar's work in other areas of the law. This sort of approach is also reflected, to some degree, in some of the standard accounts of law & economics. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 19 (1991) (arguing that one must evaluate the comparative costs and

Viewed in this light, *Omnicare* starts to make sense. The Court's decision to apply *Unocal* was driven not by traditionally expressed policy or doctrinal concerns, but by a concern with the allocation of decisionmaking authority in statutory mergers between the board and the shareholders. The Court's actual application of *Unocal* also reflected an important "who decides" question, namely, who ought to decide whether a merger agreement should be completely locked-up[14] with deal protection measures? Ultimately, the Court chose itself as the decisionmaker. Further, the Court's invalidation of the complete lock-up regulated the time at which shareholders may exercise their decisionmaking authority in the statutory merger process, and did so in a way to (arguably) enhance shareholder wealth. All this underscores that corporate legal rules

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benefits of different corporate governance devices – i.e., the market and other social institutions -- to determine which is better). For other analyses which reflect this understanding *see* William T. Allen, Jack B. Jacobs, Leo E. Strine, Jr., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002)(characterizing corporate law debate over takeovers as being "centered on the question of who – the directors or the stockholders – should have the ultimate power to decide whether the corporation should be sold . . . ")(hereinafter, Allen, et al., *The Great Takeover Debate);* Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001) (stating that in "many of the most difficult problems in corporate law . . . the issue is whether directors or shareholders have decision-making power); Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence,* 19 J. CORP. L. 583, 589 (1994) (stating that "[a]ny rules applicable to the duties of a target board when faced with a pending hostile takeover must be justified in terms of the allocation of power between directors, shareholders, and courts that these rules create"); Ronald J. Gilson, *A Structural Approach to Corporations: the Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 831 (1981) (explaining that legal problems should be approached "through a broader examination of the appropriate allocation of responsibility between management and shareholders").

[14] As discussed below, the particular deal protection measures at issue in *Omnicare* constituted a "complete lock-up" of the deal because they absolutely prevented the deal from being terminated between the time the agreement was signed and closing. This is because the deal protection measures required the board to submit the agreement to the shareholders no matter what, and required shareholders holding a majority of the votes to vote in favor of the merger no matter what.

function to allocate decisionmaking authority. It also contradicts director primacy's core argument that the board is the sole corporate decisionmaker with a "nonreviewable power of discretionary fiat."[15] *Omnicare* therefore forms part of the basis (others will be discussed too) for my contention that director primacy overemphasizes the role of the board. In sum, the thesis of this Article is three-fold: that the function of corporate legal rules is to allocate decisionmaking authority among various institutions; that *Omnicare* is an example of this; and that director primacy overstates the role of the board.

I should also explain two things that this Article does not do. It does not provide a comprehensive normative analysis of *Omnicare* and does not establish an overall framework for choosing which decisionmaker is the best. The former would require the latter, and the latter is beyond the scope of my task here because it would require a more fully-formed model of corporate governance. Instead, my task in this Article is to take the first step in establishing that model. That first step is to understand the role that corporate law serves, namely, to allocate decisionmaking authority among various institutions. That is the focus of this Article and the focus of this Article's examination of *Omnicare* and director primacy. Further steps, to be undertaken in later articles, will include developing a model to choose the appropriate decisionmaker and therefore the appropriate legal rule. Typically, the appropriate institution would be the one most likely to efficiently decide the issue at hand in such a way as to advance the ultimate goal of corporate law – which many (though by no means all) agree is shareholder wealth maximization.[16]

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[15] Bainbridge, *Means and Ends*, *supra* note 8, at 569 (stating that "corporate law vests the board of directors with a nonreviewable power of discretionary fiat.")
[16] The literature on this topic is voluminous. Portions of the debate are analyzed in, among other places, Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder*

Notwithstanding these limitations, this Article does critique certain doctrinal aspects of *Omnicare* in the course of explaining what the Court did in that case. It also identifies critical issues that would have to be resolved in reaching a normative evaluation of *Omnicare* and offers some preliminary thoughts on them.

Part II describes director primacy and its normative and descriptive claims.[17] Part III describes *Omnicare* and the Court's reasoning.[18] Part IV argues that corporate legal rules function to allocate decisionmaking authority, and uses this proposition to critique director primacy and explain *Omnicare*.[19] Part V is a preliminary normative analysis of the *Omnicare* Court's decisionmaker choices.[20] Part VI addresses some possible objections to my critique of director primacy.[21] Part VII concludes.

II. DIRECTOR PRIMACY

Professor Stephen Bainbridge's director primacy model makes claims about both the ends and means of corporate governance. As for the ends, director primacy adopts the widely held (though far from unanimous[22]) notion that a corporation should be run for the benefit of its stockholders, i.e., shareholder wealth maximization.[23] As for the means

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Primacy, 75 S. CAL. L. REV. 1189 (2002); Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991).

[17] *See infra* notes 22 through 53 and accompanying text.

[18] *See infra* notes 54 through 145 and accompanying text.

[19] *See infra* notes 146 through 239 and accompanying text.

[20] *See infra* notes 240 through 285 and accompanying text.

[21] *See infra* notes 286 through 314 and accompanying text.

[22] *See supra* note 16 and sources cited therein.

[23] Bainbridge, *Means and Ends*, *supra* note 8, at 550 (". . . director primacy treats the corporation as a vehicle by which the board of directors hires various factors of production.")

to achieve this end, director primacy posits – as the name implies – that the board of directors is the paramount decisionmaking body in the corporate governance structure.

Actually, "paramount" understates the role of the board in director primacy. For Professor Bainbridge, the board is not just a first among equals or a "mere agent of the shareholders."[24] Instead, the board's powers are "original and undelegated."[25] The board is a "Platonic guardian – a *sui generis* body . . . whose powers flow not from the shareholders alone" but from "the complete set of contracts constituting the firm."[26] The director primacy model goes so far as to conceptualize the corporation "as a vehicle by which the board hires various factors of production."[27] Put differently, "the directors in the performance of their duty possess [the corporation's property], and act in every way as if they owned it."[28]

Director primacy is not modest about the board's decisionmaking power. As a descriptive matter, it claims "corporate law vests the board of directors with a nonreviewable power of discretionary fiat."[29] As a normative matter, it claims that the board "ought to have virtually unconstrained freedom to exercise business judgment."[30] Director primacy flatly rejects any notion that shareholders (or anyone else) wield

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[24] Bainbridge, *Means and Ends*, *supra* note 8, at 550-51.
[25] Bainbridge, *Means and Ends*, *supra* note 8, at 560 *quoting* Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918).
[26] Bainbridge, *Means and Ends*, *supra* note 8, at 560.
[27] Bainbridge, *Means and Ends*, *supra* note 8, at 550.
[28] Bainbridge, *Takeovers*, *supra* note 8, at 802 *quoting* Manson v. Curtis, 119 N.E. 559, 562 (N.Y. 1918).
[29] Bainbridge, *Means and Ends, supra* note 8, at 569.
[30] Bainbridge, *Nexus of Contracts*, *supra* note 8, at 8.

ultimate direct or indirect control over the firm.[31] In sum, if the question "who decides" lies at the heart of corporate law, then Professor Bainbridge's answer is unequivocal: The board.[32]

Why give such power to the board? To protect what Bainbridge views as the "chief economic virtue" of the modern public corporation.[33] According to Bainbridge, "the chief economic virtue of the public corporation is not that it permits the aggregation of large capital pools, but rather, that it provides a hiercharchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders creditors, and other inputs."[34] Under such conditions, "the need for speed in decisions" and "authoritative control at the tactical level is essential for success."[35] Someone must be in charge and be able to make timely and binding decisions on behalf of the firm.[36] In other words, someone must have centralized decisionmaking authority and the power of fiat.[37] For Bainbridge, that someone is the board. And protecting the board's power of fiat and the efficiencies that flow from it "can be ensured only by preserving the board's decisionmaking authority from being trumped by either the shareholders or the courts."[38] Hence Bainbridge's strong claim for directorial decisionmaking power.

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[31] Bainbridge, *Means and Ends*, *supra* note 8, at 550 (stating that "[n]either shareholders nor managers control corporations – boards do.")
[32] Bainbridge, *Takeovers*, *supra* note 8, at 818.
[33] Bainbridge, *Means and Ends*, *supra* note 8, at 572.
[34] Bainbridge, *Means and Ends, supra* note 8, at 572.
[35] Bainbridge, *Means and Ends*, *supra* note 8, at 572.
[36] Bainbridge, *Means and Ends*, *supra* note 8, at 572.
[37] Bainbridge, *Nexus of Contracts*, *supra* note 8, at 603.
[38] Bainbridge, *Nexus of Contracts*, *supra* note 8, at 7.

Kenneth Arrow's *The Limits of Organization* provides theoretical backing for the director primacy model.[39] In that work, Arrow grappled with the problem of how an organization makes choices about what to do and how to do it. In order to make such choices the organization needs to coordinate the activities of its members and receive and process information gathered from various sources. Arrow described two potential decisionmaking models: the consensus-based model and the authority-based model. The choice of model for any given organization is based largely on different assumptions about the costs of information gathering, processing and transmission. Consensus-based models may be appropriate where the members of the organization have identical interests and information. Identity of interests may be assumed if the members of the group have "a sufficiently overriding commonly valued purpose."[40] A general partnership with a few partners who all participate actively in the business may be a good fit for the consensus model.

If, however, the members of the group have differing interests or information then an authority-based model may be more appropriate. This is because it is expensive to collect the information necessary for a decision, transmit that information to all the constituents of the firm, and attempt to reach a group decision. Instead, it may be more efficient to transmit the information gathered from various sources to one central place or "central office" than to disseminate it to everyone individually. Similarly, it may be more efficient for the central office to make a collective decision on behalf of the members of the organization and then transmit that decision rather than transmit all the information

[39] For an earlier and related application of Arrow's work to corporate law *see* Michael P. Dooley, *Two Models of Corporate Governance*, 27 BUS. LAW. 461 (1992).
[40] KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 70 (1974).

on which that decision was based and have the individual members of the organization make a collective decision based on that information.[41] In sum, "authority, the centralization of decision-making, serves to economize on the transmission and handling of information."[42]

The modern public corporation is a natural fit for the authority model. A consensus model based on, for example, shareholder choice, would be inappropriate because shareholders have widely divergent interests and different levels of information.[43] For example, although shareholders may share the same goal of wealth maximization, they may differ as to how to achieve that goal once uncertainty is introduced as to which course of action will effectuate that goal.[44] Accordingly, Bainbridge flatly rejects any notion that shareholders do or should exercise ultimate direct or indirect control over the corporation.[45] In other words, the board is Arrow's "central office" which gathers information, makes a decision based on that information, and then transmits that decision to the shareholders.

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[41] ARROW, *supra* note 40, at 68-69.
[42] ARROW, *supra* note 40, at 69.
[43] Bainbridge, *Means and Ends*, *supra* note 8, at 558 (arguing that it "is very hard (if not impossible) to imagine a modern public corporation that could be effectively run using consensus-based decisionmaking mechanisms. . . . neither shareholders, employees, nor any other constituency has the information or the incentives necessary to make sound decisions on either operational or policy questions. Overcoming the collective action problems that prevent meaningful involvement by the corporation's various constituencies would be difficult and costly.")
[44] Bainbridge, *Means and Ends*, *supra* note 8, at 558. Relatedly, Bainbridge notes that shareholders suffer from well-accepted collective action problems. They tend to be rationally apathetic, and free-riding is an additional disincentive to action.
[45] Bainbridge, *Means and Ends*, *supra* note 8, at 572 (stating that "In sum, shareholders lack either direct or indirect mechanisms of control.")

Bainbridge acknowledges that the board's significant authority must be balanced by accountability to shareholder interests (i.e., the shareholder wealth maximization norm). Indeed, balancing authority and accountability is "the central problem of corporate law."[46] Accordingly, "the director primacy model does not contend that the board should have wholly unfettered authority. In some cases, accountability concerns become so pronounced as to trump the general need for deference to the board's authority."[47] Accountability mechanisms include the limited right to vote that public shareholders have, the market for corporate control, and judicial review.[48] All of these mechanisms help to ensure that the board is loyal to shareholder interests. For example, if the board does not pursue shareholder wealth maximization goals then its members may be sued,[49] or the corporation's stock price may fall, making the corporation a target of a hostile takeover bid in which the directors will be replaced.

Notwithstanding the need for such balancing, Bainbridge cautions that at some point claims of accountability and authority cannot be reconciled, and that one cannot have more of one without less of the other.[50] When this happens, he leaves no doubt about which value should (at least usually, if not almost always) prevail when there is a clash between authority and accountability. He explains that given the significant virtues of vesting non-reviewable authority in the board, "[p]reservation of director discretion

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[46] Bainbridge, *Means and Ends, supra* note 8, at 605.
[47] Bainbridge, *Nexus of Contracts, supra* note 8, at 32.
[48] *See* Bainbridge, *Takeovers*, *supra* note 8, at 805.
[49] *See, e.g.,* Revlon, 506 A.2d 173 (board of directors improperly considered elevated interests of noteholders over those of stockholders); Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919) (famously holding that a corporation "is organized and carried on primarily for the profit of the stockholders.")
[50] Bainbridge, *Means and Ends, supra* note 8, at 603.

should always be the null hypothesis."[51] Bainbridge even cautions that "[i]nvestor involvement in corporate decisionmkaing threatens to disrupt the very mechanism that makes the public corporation practicable; namely, the centralization of essentially nonreviewable decisionmaking authority in the board of directors."[52] In sum, director primacy has two central premises. First, the board is the decisionmaker for corporation, and no other institution has direct or indirect control. Second, limits on the board's decisionmaking authority are derived solely from balancing the virtues of authority and accountability (with thumb firmly planted on the "authority" side of the scale).

I like director primacy. It is descriptively accurate because it reflects the significant deference to board decisionmaking inherent in much corporate law (e.g., the business judgment rule). It is also normatively attractive. It provides a compelling account of why corporate law ought to defer to directorial decisionmaking. Director primacy points out the significant benefits of such deference and the significant costs that might be incurred if such deference were not shown. Director primacy also focuses on the institutional aspect of corporate legal rules because it focuses on the costs and benefits of assigning decisionmaking to the board and develops its model of board supremacy based on that analysis. It also aptly identifies the significant costs inherent in assigning decisionmaking to shareholders. I particularly like director primacy's rejection of the notion that shareholders ought to be the (or a) corporate decisionmaker simply because they "own" the corporation or because the directors are somehow "agents" for

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[51] Bainbridge, *Takeovers*, *supra* note 8, at 807.
[52] Bainbridge, *Takeovers*, *supra* note 8, at 807.

the shareholders.[53] These notions miss the point that corporate legal rules function to assign decisionmaking authority among various institutions. Authority should be vested in a given institution only if that institution is best suited to furthering shareholder wealth maximization. There is no *a priori* reason that shareholders are going to be better than the board at doing this, and compelling reasons to believe that shareholders will often be much worse. Notwithstanding these important benefits of the model, however, director primacy also has a weakness. Its relentless focus on the role of directors and on justifying that role has led it to overlook the important (albeit limited) situations in which corporate legal rules vest decisionmaking authority elsewhere. We will return to this weakness in Part IV, after a description of *Omnicare*.

III. OMNICARE V. NCS HEALTHCARE

A. *The Facts*

Omnicare centered around the efforts of NCS Healthcare, and its board and controlling stockholders, to engage in a merger with or sale to another company.[54] NCS had a dual class common stock structure consisting of Class A and Class B shares.[55] Both classes were identical in every respect, except that Class B shares had 10 votes per share and Class A shares had only 1 vote per share.[56] The owners of the Class B shares

[53] Bainbridge, *Means and Ends*, *supra* note 8, at 551 (stating that "Shareholders do not own the corporation and, accordingly, directors are not stewards of shareholder wealth."); *id*. at 550 (stating that "the board of directors is not a mere agent of the shareholders"); *id.* at 572 (explaining that "[i]n contrast to shareholder primacy, the director primacy model takes contractarian theory to its logical extreme by severing the link between means and ends – the allocation of control and the identification of legitimate corporate ends.")
[54] Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 918 (Del. 2003).
[55] *Id*. at 918-919.
[56] *Id*.

would therefore have a voting interest disproportionately large in comparison to their equity interest. NCS had this capital structure when it went public.[57] Through their ownership of Class B shares, NCS Board Chairman Jon Outcalt and NCS President and CEO Kevin Shaw controlled over 65% of the voting power but only 20% of equity.[58]

By late 1999, NCS had fallen on hard economic times and became insolvent.[59] The price of its common stock plummeted from above twenty dollars per share to nine cents per share, and it was in default on its senior bank loan and on over $100 million of convertible debentures.[60] NCS began to explore strategic options to address these financial problems.[61] It hired UBS Warburg investment bank to contact over fifty different entities to solicit interest in a transaction with NCS.[62] This effort, however, produced only one inadequate expression of interest.[63] In December 2000, NCS fired UBS Warburg and hired Brown, Gibbons, Lang & Company as its financial advisor.[64] Meanwhile, NCS's financial position continued to deteriorate and "full recovery for NCS's creditors was a remote prospect, and any recovery for NCS stockholders seemed impossible."[65]

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[57]Omnicare, Inc. v. NCS Healthcare, Inc., 2002 WL 31445163, *1 (Del. Ch. Oct. 29, 2002).
[58] Omnicare, 818 A.2d at 918-19.
[59] *Id*. at 920.
[60] *Id*.
[61] *Id*.
[62] *Id*. at 920-21.
[63] *Id*. at 920.
[64] *Id*. at 921.
[65] *Id*.

In summer of 2001, NCS invited Omnicare to discuss possible transactions.[66] Omnicare eventually made a proposal to acquire NCS out of bankruptcy for a purchase price "substantially lower" than the face amount of NCS's debt.[67] This transaction would have provided nothing to NCS's stockholders.[68] NCS tried to negotiate a better deal with with Omnicare, but Omnicare responded that it was not interested and discussions between the two stopped.[69] Subsequently, Omnicare began discussions with NCS's creditors to continue to pursue a acquisition of NCS in bankruptcy. At about this time, another possible acquirer emerged, Genesis. Genesis had a history with Omnicare, and had previously lost a bidding war with Omincare in a different transaction. As a result, relations between Omnicare and Genesis were "bitter."

By early 2002, NCS's operating condition started to improve and it seemed possible that NCS might be able enter into a transaction that provided for some recovery for its stockholders. NCS decided to form an independent committee of board members that were neither employees nor major stockholders. It did this because it thought that its precarious financial position meant it owed duties to its creditors as well as to its stockholders.[70] The independent committee consisted of the two members of NCS's four member board that were neither employees nor major stockholders.[71] The other two members of the board were Outcalt and Shaw.[72] The independent committee had

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[66] *Id*.
[67] *Id*.
[68] *Id*.
[69] *Id*.
[70] When a corporation becomes insolvent it may owe fiduciary duties to creditors as well as shareholders.
[71] *Id*. at 922.
[72] *Id*.

authority to consider and negotiate a possible transaction for NCS but the full board retained authority to approve any transaction.[73] The independent committee also retained the same legal and financial counsel as the NCS board.[74] The independent committee decided to seek a "stalking-horse merger parter" to obtain the highest possible value in any transaction.[75] This meant that the committee would try to find an interested buyer and then use that buyer's interest to stir-up interest from other buyers and (hopefully) cause a bidding war to erupt.

When Genesis representatives met with NCS, however, they made it clear that they would not allow Genesis to be used as a stalking horse.[76] After intensive negotiations, Genesis proposed to acquire NCS outside of bankruptcy for an amount that included recovery for NCS's stockholders.[77] But Genesis demanded that NCS enter into an exclusivity agreement with it as a condition to further negotiations.[78] Pursuant to this agreement NCS would negotiate exclusively with Genesis for a short period of time (about a month).[79] NCS signed the exclusivity agreement and continued to negotiate with Genesis.[80] During these negotiations, NCS persuaded Genesis to continue to improve the terms of its offer.[81] It was also clear during these negotiations that Genesis would insist that any merger agreement between it and NCS be completely locked-up to preclude the

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[73] *Id*.
[74] *Id*.
[75] *Id*.
[76] Omnicare, 818 A.2d at 922.
[77] *Id*.
[78] *Id*.
[79] *Id*. at 922-23.
[80] *Id*. at 923.
[81] *Id*. at 923-25.

possibility of a later, higher bid by Omnicare.[82] Genesis was clearly worried that Omnicare would attempt to "steal" another deal from it.[83]

Omnicare, in the meantime, started to become suspicious that NCS was negotiating with another party.[84] It therefore made another proposal to acquire NCS.[85] This time the proposal did not involve putting NCS into bankruptcy and provided for a recovery for NCS's stockholders.[86] The proposal, however, contained a "due diligence out" allowing Omnicare the chance to investigate NCS's condition further and to withdraw its proposal if it didn't like what it found.[87] NCS's board met to consider the proposal and concluded that pursuing negotiations with Omnicare would violate NCS's exclusivity agreement with Genesis and present an "unacceptable risk" of losing the Genesis deal.[88] But NCS did decide to use the Omnicare proposal as leverage to negotiate for improved terms with Genesis.[89]

Genesis responded with "substantially improved terms," including an agreement to retire NCS's outstanding notes in accordance with their terms plus the payment of a small redemption premium, an 80% increase in the amount of Genesis common stock being offered to NCS shareholders, and a reduction in the termination fee of the agreement.[90]

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[82] *Id*. at 923.
[83] *Id*.
[84] *Id*. at 924.
[85] *Id*. at 924.
[86] *Id*. at 924.
[87] *Id*.
[88] *Id*.
[89] *Id*.
[90] *Id*. at 924-25.

In return for these concessions, Genesis demanded that NCS respond by midnight the next day.[91]

NCS's independent committee and then its board met and decided to accept the Genesis proposal, including deal protection provisions that would "completely lock up" the merger transaction.[92] The deal protection provisions were threefold. First, the agreement required the NCS board to submit the Genesis deal to a shareholder vote regardless of what happened between the time the agreement was signed and the shareholder meeting was held, and regardless of whether the NCS board still believed at that time that the Genesis deal was the best for its shareholders (a "force the vote" provision).[93] Second, Outcalt and Shaw would agree to irrevocably vote in favor of the Genesis transaction no matter what (a "voting lock-up").[94] Third, there would be no fiduciary-out in the merger agreement to allow NCS to consider subsequent bids.[95] NCS's board agreed to these strict terms after "balancing the potential loss of the Genesis deal against the uncertainty of Omnicare's" proposal.[96]

After the NCS/Genesis proposal was announced, Omincare initiated litigation to attempt to enjoin the merger and announced a tender offer for NCS shares.[97] Omnicare

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[91] *Id*. at 925.
[92] *Id*.
[93] Omnicare*,* 818 A.2d at 925-26.
[94] *Id*.
[95] *Id.* A "fiduciary-out" would have allowed NCS to consider other bids and terminate the merger agreement upon certain contingencies. For a good explanation of fiduciary-outs and the restrictions from which they provide an "out" *see* William T. Allen, *Understanding Fiduciary Outs: The What and the Why of an Anomalous Concept*, 55 BUS. LAW. 653 (2000).
[96] *Id*. at 925.
[97] *Id*. at 926.

also expressed an interest in discussing the terms of its offer with NCS.[98] Omnicare's proposal, however, still contained a "due diligence out."[99] NCS requested and received a waiver from Genesis allowing NCS to enter into discussions with Omnicare.[100] Soon after, Omnicare made an irrevocable offer to acquire NCS for $3.50 per share.[101] The value of this offer was significantly higher than the Genesis offer. NCS's board then withdrew its recommendation of the Genesis deal.[102] But this change of recommendation was meaningless given the deal protection measures built into the NCS/Genesis merger agreement.[103] Since Outcalt and Shaw (controlling a majority of NCS votes) had irrevocably committed to vote in favor the Genesis transaction, and since NCS had irrevocably committed to submit that transaction to a shareholder vote, there was no way for NCS to escape the deal.[104] It was "completely locked-up." Litigation then ensued to stop the NCS-Genesis merger.[105] The focus of the case was on the validity of the deal protection measures.

B. *The Court's Decision*

1. INTRODUCTION

There were three important components to the Court's decision. Subpart 2 describes the Court's decision to apply *Unocal* enhanced scrutiny to the deal protection

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[98] *Id*. at 926-27.
[99] *Id*. at 926.
[100] *Id*.
[101] *Id*.
[102] *Id*.
[103] *Id*. at 926-27.
[104] *Id*.
[105] *Id*. at 927.

measures.[106] Subpart 3 describes the Court's decision to invalidate the deal protection measures under *Unocal*.[107] Subpart 4 describes the Court's decision to invalidate the deal protection measures on the independent grounds that they were "invalid as they operate[d]" in *Omnicare*.[108] Each of these elements of the Court's decision will be explored further in Part IV below.[109]

2. THE STANDARD OF REVIEW

The first order of business for the Court was to determine the level of judicial scrutiny to apply to its review of the challenge to the deal protection measures. There are generally three standards of review: the highly deferential business judgment rule, intermediate or "enhanced" scrutiny, and the exacting entire fairness standard.[110] In an important holding, the Court decided to apply enhanced scrutiny to the deal protection measures in the agreement between NCS and Genesis.[111]

The particular type of enhanced scrutiny that the Court decided to apply is known as "*Unocal*" scrutiny, after the case in which it was created. Traditionally, *Unocal* applies when the board of directors of a target company takes defensive measures to ward-off a pending or potential hostile takeover.[112] A classic example is the adoption of a poison pill.[113] The question in *Omnicare*, then, was whether deal protection devices – like the voting lock-up and the force-the-vote provision – that are contained in a

[106] *See infra* notes 110 through 123 and accompanying text.
[107] *See infra* notes 124 through 138 and accompanying text.
[108] *See infra* notes 139 through 145 and accompanying text.
[109] *See infra* notes 146 through 238 and accompanying text.
[110] *E.g.,* Hanewicz, *supra* note 4, at 210-11, 215-20.
[111] Omnicare, 818 A.2d at 931.
[112]Unocal, 493 A.2d at 954-55.
[113] Moran v. Household Intern., Inc., 500 A.2d 1346 (Del. 1985).

negotiated merger agreement and are designed to protect the deal against potential future bidders should be treated under *Unocal* like defensive measures such as a poison pill.[114]

To resolve this issue, the Court focused on the respective roles that the board and shareholders should play in the negotiated acquisition process.[115] The Court explained that "Delaware law expressly provides for a balance of power between boards and stockholders" with regard to mergers.[116] Presumably, the Court is referring to Delaware s. 251 which provides that the board acts as a gatekeeper and must approve any merger agreement before it is submitted to the stockholders for their vote.[117] The stockholders then must approve the merger (typically by a majority vote) before the merger can be consummated.[118] The Court explained that any board decision to adopt deal protection measures "may implicate the stockholders' right to effectively vote contrary to the initial recommendation of the board in favor of the transaction."[119] The Court continued that it was "well established that conflicts of interest arise when a board of directors acts to prevent stockholders from effectively exercising their right to vote contrary to the will of the board."[120] The Court then quoted the key portion of the *Unocal* decision and concluded that it was the "omnipresent specter" of such a conflict that justified *Unocal's* enhanced scrutiny.[121] The Court further explained the type of conflicts it had in mind:

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[114] For an analysis of this issue *see* Hanewicz, *supra* note 4, at 226-38.
[115] Omnicare, 818 A.2d at 930-31.
[116] *Id*. at 930.
[117] *See* Del. St. Ann. S. 251(b); Hanewicz, *supra* note 4, at 216; *see also* Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 320-21 (noting the gatekeeper role).
[118] DEL. CODE ANN. Tit. 8 s. 251(c)(2001).
[119] Omnicare, 818 A.2d at 930.
[120] *Id*.
[121] *Id*.

"There are 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 disapprove the merger, and the board's continuing responsibility to effectively exercise its fiduciary duties at all times after the merger is executed."[122] Because of these conflicts, enhanced scrutiny applied.[123]

3. INVALIDATION UNDER UNOCAL

Unocal scrutiny consists of a two-part test, with the defendant board bearing the burden of proof on each part.[124] First, the defendant board must prove that it "had reasonable grounds for believing that a danger to corporate policy and effectiveness existed."[125] To establish this, the board must show that it acted in good faith after conducting a reasonable investigation.[126] Although the opinion is a little ambiguous on this point, the Court apparently thought the NCS board satisfied this first prong. The identified threat was the possibility of losing the Genesis offer and being left with no comparable alternative transaction.[127]

The second part of the *Unocal* test requires the board to demonstrate that its deal protection measures were "reasonable in relation to the threat posed."[128] This, in turn, requires a two-prong analysis. First, the deal protection measures must not be "coercive"

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[122] *Id*.
[123] *Id*. at 930-31.
[124] Unocal, 493 A.2d at 955-56.
[125] Unocal, 493 A.2d at 955.
[126] *Id*.
[127] Omnicare, 818 A.2d at 935.
[128] Unocal, 493 A.2d at 955.

or "preclusive."[129] Second, if the deal protection measures are neither "coercive" nor "preclusive" then they will be upheld if they are "within a range of reasonableness."[130]

The focal point of the *Unocal* test is the "coercive" or "preclusive" prong. "A response is "coercive" if it is aimed at forcing upon stockholders a management – sponsored alternative to a hostile offer."[131] "A response is "preclusive" if it deprives stockholders of the right to receive all tender offers or precludes a bidder from seeking control by fundamentally restricting proxy contests or otherwise."[132] The Court concluded that NCS's defensive measures were both coercive and preclusive.[133]

The Court held that the NCS stockholder vote would be coerced because of the combined effect of the voting lock-up and force the vote provisions, neither of which had a fiduciary-out.[134] These voting lock-ups would have forced the public stockholders to accept the Genesis merger regardless of how they voted because over 60% of NCS's voting power was tied to the voting lock-ups.[135] The Court noted that owners of over 80% of NCS's stock would thereby be disenfranchised.[136] Their votes wouldn't count. Even though the public stockholders could vote against the merger, they would be forced to

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[129]Unitrin v. Am. Gen. Corp., 651 A.2d 1361, 1387-88 (Del. 1995).
[130]Omnicare, 818 A.2d at 935.
[131] Omnicare, 818 A.2d at 935. The Court in *Omnicare* also described coercion as occurring when "the board or some other party takes actions with have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of the transaction." *Id*.
[132]*Id*.
[133] *Id*. at 936.
[134] *Id*. at 935-36.
[135] *Id*.
[136] *Id*. Recall that as a result of the dual class voting structure, the public stockholders held 80% of NCS's shares but less than 50% of the votes. Outcalt and Shaw, on the other hand, owned 20% of the shares but controlled over 50% of the votes.

accept it nonetheless because the deal protection measures made the merger a *fait accompli*.[137] For good measure, the Court also says that these same reasons make the deal protections "preclusive."[138]

4. INVALIDATION FOR LACK OF AUTHORITY

Just to make sure the point was made, the Court also invalidated the deal protection measures on grounds entirely separate from *Unocal*.[139] The Court concluded that the deal protection measures were "invalid as they operate in this case."[140] Why? Because the voting lock-up and force-the-vote provisions, coupled with the lack of a fiduciary out, "completely prevented the board from discharging its fiduciary responsibilities to the minority stockholders when Omnicare presented its superior transaction."[141]

The Court noted that minority stockholders typically have very limited rights vis-à-vis a controlling shareholder. In particular, minority stockholders have no power to "influence corporate direction through the ballot."[142] Accordingly, since minority stockholders cannot protect themselves, they "must rely for protection solely on the fiduciary duties owed to them by the directors."[143] The Court explains that the board has a "continuing obligation to discharge" these "unremitting" fiduciary duties, and that the board cannot "disable[] itself from exercising" these duties by agreeing to a completely

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[137] *Id*. at 936.
[138] *Id*. The Court did not appear to engage in a separate "preclusion" analysis.
[139] *Id*. at 936-39.
[140] *Id*. at 936.
[141] *Id*.
[142] Omnicare, 818 A.2d at 937.
[143] Omnicare, 818 A.2d at 937.

locked-up merger agreement.[144] Accordingly, the "NCS board was required to contract for an effective fiduciary out clause to exercise its continuing fiduciary responsibilities to the minority stockholders."[145]

IV. Analysis of Director Primacy and Omnicare

A. *Introduction*

This Part intertwines my critique of director primacy with my analysis of *Omnicare*. Each of the following five subparts supports my contentions that director primacy's claims are too strong and that corporate legal rules function to allocate decisionmaking authority to different institutions, including but not limited to, the board. Subpart B elaborates on my overall critique of director primacy. Subpart C argues that – contrary to director primacy's claims – the statutory merger process allocates important control rights to shareholders. Subpart D argues that *Omnicare*'s extension of *Unocal* to deal protection measures demonstrates that the Delaware Supreme Court also views legal rules as a tool to allocate decisionmaking authority. Subpart E explains how *Omnicare* allocates decisionmaking authority to the Court. Subpart F explains how *Omnicare* regulates the allocation of decisionmaking authority to the shareholders in statutory mergers in such a way as to (arguably) advance shareholder wealth maximization.

B. *Elaboration on My Critique*

Director primacy's central claims are too strong. Director primacy claims that the board is a "Platonic guardian"[146] with "essentially nonreviewable"[147] discretion to govern

[144] *Id*. at 936-39.
[145] Omnicare, 818 A.2d at 939.
[146] Bainbridge, *Takeovers*, *supra* note 8, at 795.

a corporation.[148] Director primacy also flatly rejects the notion that shareholders (or anyone else) have ultimate direct or indirect control over the firm.[149] It is true that often – maybe even almost always -- the board has the final say on corporate matters and that neither the courts nor the shareholders will overturn its decision. The Delaware Corporate Code reflects this principle when it mandates that a corporation's business and affairs "shall be managed by or under the direction of a board of directors."[150] So too with the near-ubiquitous business judgment rule, which "exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors."[151] I do not dispute that the board does or should have wide-ranging authority to run the corporation free from interference from either the courts or the shareholders. But there are exceptions to the board's wideranging authority and the exceptions are important. These exceptions include such fundamental and controversial issues as hostile takeovers and negotiated acquisitions (which are the focus of *Omnicare* and this Article). These exceptions demonstrate that the board is not the only decisionmaker and that at critical times other institutions (such as the courts or the shareholders) have the final say on corporate matters. The board's authority is not quite as expansive as director primacy asserts.

Professor Bainbridge does, of course, acknowledge limits on the board's power and argues that "deterrence and punishment of board misconduct is necessary . . ."[152] In

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[147]Bainbridge, *Takeovers*, *supra* note 8, at 807.
[148] *See supra* notes 22 through 52 and accompanying text.
[149]Bainbridge, *Means and Ends*, *supra* note 8, at 563 (stating "director primacy . . . rejects the notion that shareholders are entitled to either direct or indirect decisionmaking control.")
[150] DEL. CODE ANN. Tit. 8, s. 141(a).
[151] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 2003).
[152] Bainbridge, *Means and Ends, supra* note 8, at 551.

director primacy, however, these limits on the board's authority occur only within the context of balancing authority and accountability,[153] and Bainbridge denies that such balancing should divest the board of decisionmaking authority.[154] For example, he cautions that judicial review of transactions fraught with conflict-of-interest might be the subject of "stricter-than-normal policing" but cautions that "this does not mean that we must set aside authority values by divesting the board of decisionmaking authority."[155]

I respectfully disagree. Corporate legal rules directly implicate the fundamental question of "who decides,"[156] do (at times) divest the board of decisionmaking authority, and do allocate that authority to other institutions. The Delaware Supreme Court recently said as much in its recent *MM Companies v. Liquid Audio* decision.[157] According to the *Liquid Audio* Court: "The most fundamental principles of corporate governance are a function of the allocation of power within a corporation between its stockholders and its directors."[158] The Court also acknowledged the important role of the judiciary as decisionmaker: "The 'defining tension' is corporate governance today has been characterized as 'the tension between deference to directors' decisions and the scope of

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[153]Bainbridge, *Means and Ends*, *supra* note 8, at 573 ("Neither discretion nor accountability can be ignored because both promote values essential to the survival of business organizations. . . . Establishing the proper mix of discretion and accountability thus emerges as the central concern of corporate governance.")
[154]Bainbridge, *Takeovers, supra* note 8, at 811.
[155] Bainbridge, *Takeovers*, *supra* note 8, at 811.
[156] I believe both Bainbridge and I agree that "who decides" is a – if not the -- fundamental question to be answered. *See* Bainbridge, *Takeovers*, *supra* note 8, at 792 (stating "Who decides? This question lies at the heart of corporate takeover jurisprudence.")
[157] MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118, 1126 (Del. 2003).
[158] *Id*. at 1126.

judicial review.'"[159] Further driving home this point, the *Liquid Audio* court cited approvingly and at length former Chancellor Allen's[160] explanation of why board actions taken to prevent shareholders from electing a new majority of board members are particularly suspect: "[such actions] involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation . . ."[161] These statements are powerful support for my contention about the function of corporate legal rules.

To be fair, Professor Bainbridge forthrightly acknowledges that the Court has "not explicitly embraced director primacy, especially in the strong form" he advocates.[162] Nonetheless, he does make claims about the relative descriptive accuracy of director primacy.[163] I also claim relative descriptive accuracy for my thesis that corporate legal rules function to allocate decisionmaking authority among various institutions, not limited to the board. The expressed views of the Delaware Supreme Court are certainly not irrelevant to this descriptive claim and support my position.

For further support, consider two standards of review applicable to director actions under Delaware law: the business judgment rule and entire fairness. If a court

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[159] *Id*. at 1127 (quoting E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393 (1997). Mr. Veasey is the Chief Justice of the Delaware Supreme Court.
[160] Mr. Allen is now a professor at New York University School of Law and was a highly-esteemed corporate law jurist.
[161] MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118, 1128 (Del. 2003) (quoting Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659-60 (Del. Ch. 1988)).
[162] Bainbridge, *Takeovers*, *supra* note 8, at 814.
[163] *Id*. (stating that he is "making the descriptive claim that director primacy explains Delaware law better than does shareholder primacy.")

applies the business judgment rule[164] then the challenged board action will almost certainly be validated.[165] In other words, the business judgment rule results in the board being the decisionmaker. Indeed, the Delaware courts have specifically eschewed reviewing the substance of any board decision protected by the business judgment rule. Thus, in *Brehm v. Eisner*[166] the Delaware Supreme Court explained that "[c]ourts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is *process* due care only."[167] On the other hand, under the exacting entire fairness standard of review[168] a

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[164]According to the Delaware Supreme Court, the business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company." *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000). To rebut the business judgment rule, the plaintiff must demonstrate that the challenged transaction involved a conflict of interest (in which case entire fairness usually applies) or that the board's decision was based on a grossly negligent decisionmaking process. *E.g.* Hanewicz, *supra* note 4, at 217. The latter is extremely difficult to demonstrate, the notable exception being the widely-criticized *Smith v. Van Gorkom*. 488 A.2d 858 (Del. 1985); *see also* W. KLEIN & J. COFFEE, BUSINESS ORGANIZATIONS AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 151 (7th Ed. 2000.) That said, the Delaware Supreme Court has, at least in theory, reserved the possibility that in some future case it might find a violation of the duty of care for substantive – and not simply procedural – reasons. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367 (Del. 1994) ("Having become so informed, they [the directors] must *then* act with requisite care in the discharge of their duties.")

[165] *E.g.* Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 Bus. Law. 919 (2001) (stating that"[a]bsent their decision to engage in a self-dealing transaction, directors know that it is incredibly unlikely that their ordinary managerial decisions will be disturbed by the Delaware courts. The business judgment rule guarantees this result."); *see also* Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 Tex. L. Rev. 591, 607 (1983) (stating that the "issue in duty of care litigation is the process, not the merits, of decision making. Courts do not make business decisions. They evaluate board procedure, a matter well within judicial competence.")

[166] 746 A.2d 244 (Del. 2000).

[167] *Id*. at 264.

court will often substitute its judgment for that of the board. The Delaware Supreme Court has explained that under entire fairness "judicial reluctance to assess the merits of the business decision ends" and the "challenged transaction must withstand rigorous judicial scrutiny."[169] The board's action is validated only if the court decides that the transaction is fair.[170] Entire fairness therefore results in the court being the decisionmaker.

In sum, the functional significance of the business judgment rule and the entire fairness standard is that they shift the locus of decisionmaking authority between the board and the courts.[171] These corporate legal rules do more than just police – they can and do divest the board of its decisionmaking authority. Other corporate legal rules function the same way.

C. *Statutory Mergers*

Statutory mergers are another context in which director primacy's claims are too strong. Bainbridge argues that statutory mergers are a "clear" example of directory primacy and right to control: the "statutory decisionmaking model is one in which the board acts and shareholders, at most react. Put simply, control is vested in the board – not

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[168] Entire fairness typically applies to a board decision when there is a conflict of interest or self-dealing involved. *See, e.g.* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1279 (Del. 1988) (explaining that entire fairness applies when the board's decision was not "disinterested").
[169] Mills Acquisition Co., 559 A.2d at 1279.
[170] *Id.*
[171] *See, e.g.,* Mills Acquisition Co. 559 A.2d at 1279 (stating that "[b]ecause the effect of the proper invocation of the business judgment rule is so powerful and the standard of entire fairness so exacting, the determination of the appropriate standard of judicial review frequently is determinative of the outcome of derivative litigation.") (*quoting* A.C. Acquisitions v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986).

the shareholders."[172] Bainbridge explains that the shareholders' right to approve a merger is an accountability device but is not a control right.[173] He argues that "market-based accountability and control–by which I mean the right to exercise decisionmaking fiat—are distinct concepts."[174] Bainbridge further explains that the "right to fire is not the right to exercise fiat—it is only the right to discipline."[175]

Again, I respectfully disagree. The distinctions between "market-based accountability" and "control" and between "the right to discipline" and the "right to exercise fiat" are not at all clear.[176] These distinctions seem to disappear altogether with respect to shareholder voting rights in statutory mergers. It is true that shareholders may vote on a merger only if the board first proposes one to them; in this sense the board is undoubtedly the gatekeeper.[177] But, it is just as true that the board may not force a merger unless the shareholders approve it.[178] So shareholders have control too, albeit a negative

[172] Bainbridge, *Takeovers*, *supra* note 8, at 801.
[173] Bainbridge, *Takeovers, supra* note 8, at 802.
[174] Bainbridge, *Takeovers*, *supra* note 8, at 802.
[175] Bainbridge, *Takeovers, supra* note 8, at 802.
[176] Professor Bainbridge also notes that other accountability mechanisms like the capital and reputation markets keep directors accountable to shareholder interests but cannot fairly be said to confer control rights on shareholders. Bainbridge, *Takeovers, supra* note 8, at 802. He argues that if these markets do not confer "control" rights, then the market for corporate control cannot be said to confer control rights either. But I think there is an important difference. The market for corporate control, at least with respect to statutory mergers, directly involves and depends on the shareholders right to vote. In this way, shareholders have important, direct and indirect, involvement in this market. They do not have the same sort of involvement in the reputation or parts of the capital markets. It is true that shareholders have involvement in the equity capital markets too because they purchase stock. But to this extent I think the equity capital markets also arguably confer control rights. They are the vehicle by which shareholders "bargain" over the terms of their equity investment contract with the corporation. To the extent they have bargaining leverage, they have a form of control.
[177] *E.g.,* Hanewicz*, supra* note 4, at 216.
[178] DEL. CODE ANN. Tit. 8, s. 251(c) (2002).

form of it. This is an explicit part of the statutory scheme.[179] If the board does not agree, there is no merger. But if the shareholders do not agree, there is no merger either. That is joint control, not board control.

Moreover, any meaningful distinction between the shareholders "right to discipline" and the board's "right to exercise fiat" (fiat equaling control) is further blurred when one considers the consequences that flow from the shareholders' negative control right. The shareholders' negative control right gives others the power to initiate alternative transactions on behalf of shareholders – transactions that the board, left to its own devices, might not otherwise consider. Such alternative transactions can take the form of a hostile takeover[180] or a friendly "topping bid" proposed after the initial friendly merger agreed to by the board is announced.[181] They can also take the form of a negotiated acquisition proposal coupled with the threat of a hostile takeover if a negotiated acquisition is not consummated. Granted, the board still retains broad discretion to defend against a hostile takeover and unilateral discretion to accept or reject a negotiated merger or asset acquisition proposal.[182] But without at least the possibility of shareholders exercising negative control by voting down the merger agreement initially approved by the board, accepting a tender offer, or siding with proxy insurgents, none of

[179] DEL. CODE ANN. Tit. 8, s. 251(c) (2002).
[180] Subject of course to the target board's formidable defenses to such an offer.
[181] Of course, such a subsequent bid, unless it went hostile, would have to get the target board's subsequent approval before being proposed to the shareholders. Again, there is a relationship between hostile bids and negotiated acquisitions.
[182] The precise extent of that discretion is open to debate and depends on part on whether the board initiates a transaction involving the "sale, breakup or change of control" of the target company. If it does, then the relatively stricter *Revlon* variant of enhanced scrutiny applies. If it does not, and simply defends an initial non-*Revlon* transaction or simply tries to "just say no" then the more deferential *Unocal* standard applies.

the alternative transactions would be particularly feasible. Yet they are feasible and do occur. Buyers have apparently decided that initially unwanted (by the board) bids still have a real chance of success.[183] In other words, buyers appear to believe that the shareholders' negative control rights are meaningful.[184] The reported cases, particularly

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[183] Recent research by Professors Bebchuk, Coates and Subramanian indicate that odds that a target will remain independent increase from 34% to 61% if there is a pill coupled with a staggered board. Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 931 (2002). While their research is designed to demonstrate the effectiveness of a combined poison pill/classified board defense, it also shows that in a significant portion of cases (66% without a combination pill/staggered board and 39% with such a combination), a target company does not remain independent.

Relatedly, Professor Bainbridge argues that the poison pill and classified boards have "gone a long way towards restoring director primacy vis-à-vis the shareholders." Bainbridge, *Takeovers, supra* note 8, at 802-03. Resolving this empirical question is beyond the scope of this Article. But I do suggest that the research of Bebchuk, et al., suggests that takeovers can still often result in the target losing its independence. Even Professor Bainbridge claims only that takeover defenses have "gone a long way towards" given directors *carte blanche*. They have not yet gone the whole way. *See also* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 1999 J. CORP. L. 837, 859 (1999) (concluding that "[i]n sum, reports of the death of the market for corporate control have been greatly exaggerated.")

[184] One might argue that a board faced with a bid that it initially does not want may itself change its mind and that this possibility – and not shareholder negative control rights - at least partially explains topping bids and the like. This is no doubt true, in part. But there are many times where it is clear that the target board does not want to break-off its initially proposed transaction. Examples include Paramount v. Time Warner, 571 A.2d 1140 (Del. 1989) and Revlon v. McAndrews & Forbes Holding Company, 506 A.2d 173 (Del. 1986). In both these cases the target board fought tenaciously to fend-off the hostile bidder and defend its favored transaction. The deal protection measures contained in the "favored transaction" agreements were not, therefore, designed to prevent the target board from changing its mind but to prevent the target company's stockholders from overruling the board.

In addition, one has to consider the impact of the shareholder negative control rights on the supposedly "voluntary" reconsideration by the board of an acquisition proposal it initially resisted. If the board did not have to face the prospect of a tender offer, proxy context or fiduciary duty suit – all of which are made possible only via shareholder negative control rights – there would likely be less reconsideration of options.

of late, support this optimism.[185] Similarly, initial merger partners must also consider subsequent bids a real risk since they frequently demand deal protection measures precisely as a way to mitigate the risk of a subsequent bidder emerging. *Omnicare* itself is a prime example because the initial bidder (Genesis) demanded a completely locked-up deal to ward off subsequent bidders. A subsequent bidder nonetheless emerged and – after winning in the Delaware Supreme Court – succeeded in acquiring the target.[186] In sum, shareholders do have important control rights in statutory mergers.[187]

D. *Omnicare's Interpretation of Unocal*

Omnicare's justification for applying *Unocal* to deal protection measures also demonstrates – in a way that is as strange as it is clear -- that legal rules function to allocate decisionmaking authority among different institutions. It is strange because the Court's stated explanation for *Unocal* enhanced scrutiny and for extending it to deal protection measures conflicts with the traditional reason justifying *Unocal*. That said, the Court clearly views *Unocal* as a tool for allocating decisionmaking authority. The following two subparts elaborate on each of these contentions.

1. OMNICARE'S BREAK FROM THE TRADITIONAL UNDERSTANDING OF UNOCAL

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[185]In 1999 the Court of Chancery decided a trilogy of important cases, all of which involved the emergence of subsequent bidders. Phelps Dodge Corp. v. Cyprus Amax Minerals Co., No. CIV.A.17398, 1999 WL 1054255 (Del. Ch. Sept. 27, 1999); ACE Ltd. v. Capital Re. Corp., 747 A.2d 95 (Del. Ch. 1999); *In re* IXC Communications, Inc. S'holders Litig., No. C.A. 17324, 1999 WL 1009174 (Del. Ch. Oct. 27, 1999).

[186] In re NCS Healthcare, Inc. S'holders Litig., 2003 WL 21384633, *1 (Del. Ch. May 28, 2003) (explaining that after the Delaware Supreme Court's decision a bidding contest between Genesis and Omnicare ensued in which Omnicare prevailed).

[187] *Accord* Allen, et al., *The Great Takeover Debate*, *supra* note 13, at 1078 (explaining that the law "gives the board of directors a central role in corporate decisionmaking, but it also requires stockholder assent for many fundamental transactions.")

The *Omnicare* court decided to apply *Unocal* because of the "omnipresent specter" of a conflict of interest inherent in deal protection measures.[188] In particular, the Court was concerned about the "inherent conflicts between a board's interest in protecting a merger transaction it has approved" and "the stockholders' statutory right to make a final decision to either approve or disapprove the merger."[189] The presence of the "omnipresent specter" of a conflict of interest is the well-known trigger for *Unocal*'s enhanced scrutiny.[190] On the surface, therefore, *Omnicare* seems to follow closely in *Unocal*'s footsteps.

But there is a problem. The "omnipresent specter" of *Unocal* and its progeny is not the "omnipresent specter" identified by the *Omnicare* court. The conflict of interest discussed in *Unocal* involved hostile takeovers and the inherently conflicted position in which they place target managers (including the board).[191] Often a hostile takeover results in the target managers losing their jobs. A hostile takeover also often results in the target shareholders being paid a substantial premium for their shares. The conflict is then plain: the target managers have an incentive to fend-off a takeover that the target shareholders may want to accept.[192] It is of course possible that the target managers may adopt defensive measures in good faith to extract a higher price from the hostile bidder through hard bargaining or to prevent the hostile bidder from coercing the target

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[188]Omnicare, 818 A.2d at 930-34.
[189] *Id.* at 930.
[190] Unocal, 493 A.2d at 954.
[191] *E.g.* Bainbridge, *Means and Ends*, *supra* note 8, at 604 n. 282.
[192] *See, e.g.,* Bebchuk, *The Case Against the Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 991 (2002) ("The takeover context is one in which managers' and shareholders' interests often diverge. Managers might lose their control and the private benefits associated with it.")

shareholders into selling on the cheap. Nonetheless, given the "omnipresent specter" of a potential conflict of interest, the *Unocal* Court adopted an "enhanced scrutiny" test to evaluate such anti-takeover measures.[193]

In *Omnicare*, this traditional conflict-of-interest simply was not present. The NCS board actively sought to sell the company and when it agreed to the deal protection measures it did so to avoid losing a sale to Genesis, not to avoid some threatened or pending offer that was of higher value to the shareholders. Quite the opposite: the board feared that if the Genesis deal fell through then Omnicare would be able to buy the company on the cheap – as it had already tried to do. The Court simply pretended not to notice this disconnect between *Unocal* and the facts before it.[194]

2. OMNICARE'S INSTITUTIONAL UNDERSTANDING OF UNOCAL

Despite its lack of doctrinal purity, the Court's reasoning is quite explicit about *Unocal*'s function. The "omnipresent specter" the Court identified exemplifies this. The conflict was not between the board's potential self-serving motives and the shareholders' interests (as in *Unocal*). It was between the allocation of decisionmaking authority to the board and the shareholders in the statutory merger scheme, in other words, it was a decisionmaker conflict. The Court explained that any board decision to adopt deal protection measures "may implicate the stockholders' right to effectively vote contrary to

[193]Unocal, 493 A.2d at 954-56.

[194] This is not to say there are no reasonable arguments for applying *Unocal* to deal protection measures. There are. I happen to believe these arguments are, to a large degree, incorrect. *See* Hanewicz, *supra* note 4, 226-38 (describing and analyzing these arguments). But regardless of where one stands on the issue, the Court's failure consider this question more openly is a serious shortcoming in its doctrinal analysis.

the initial recommendation of the board in favor of the transaction."[195] According to the Court it is "well established that conflicts of interest arise when a board of directors acts to prevent stockholders from effectively exercising their right to vote contrary to the will of the board."[196] The Court was concerned that NCS's deal protection measures did precisely that by obviating the shareholder vote on the merger and presenting the shareholders with a *fait accompli*. *Omnicare* therefore supports my thesis that corporate legal rules – in this case *Unocal* – function to allocate decisionmaking authority among various institutions, including the stockholders. That is certainly the *Omnicare* Court's understanding of *Unocal*.

Interestingly, the Court recently expressed an almost identical understanding of *Unocal* in *Liquid Audio.*[197] According to the *Liquid Audio* Court, *Unocal* (and its close doctrinal cousin, *Blasius*):

> recognize[s] the inherent conflicts of interest that arise when a board of directors acts to prevent shareholders from effectively exercising their right to vote either contrary to the will of the incumbent board members generally or to replace the incumbent board members in a contested election.[198]

Given *Liquid Audio*, *Omnicare's* interpretation of *Unocal* as being triggered by a conflict in decisionmaking authority cannot be dismissed as a lone aberration.

Alas, although the *Omnicare*'s Court's explicit acknowledgement that legal rules allocate decisionmaking authority is laudable, the Court's reasoning is suspect. In

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[195]Omnicare, 818 A.2d at 930.
[196]Omnicare, 818 A.2d at 930.
[197] 813 A.2d 1118 (Del. 2003).
[198] *Liquid Audio*, 813 A.2d at 1129. It may be worth noting that *Liquid Audio* was a unanimous opinion in which Justice Steele joined. Justice Steele was one of two dissenters in *Omnicare*. The unanimous nature of *Liquid Audio* may therefore suggest that the members of the Court share the *Omnicare* Court's (and my) interpretation of *Unocal* as being about a conflict in decisionmaking authority.

addition to fudging the traditional *Unocal* trigger, the Court overlooked an important fact: shareholders controlling a majority of votes approved of the deal protection measures agreed to by the board. It is hard therefore to generate much excitement over the supposed "conflict" between the decisionmaking authority of the board and the shareholders -- at least if "shareholders" for this purpose are identified as including those controlling a majority of the votes. A little more work will therefore be needed to make sense of this part of *Omnicare*. Specifically, we need an explanation for why the Court seemed to ignore the role of the controlling shareholders in approving of the deal protection measures. Subpart F below undertakes this task.

Finally, one has to have some sympathy for the Court's doctrinal plight. In fairness to the Court, it tried to do its best with the tools it had. If the Court wanted to ensure that a "meaningful" (i.e., where the result is not pre-ordained by voting agreements) shareholder vote took place then its options were limited. The business judgment rule wouldn't do because its mere invocation would have sent the plaintiffs packing. Nor did the NCS board act in a "grossly negligent" manner in informing itself like the board in *Van Gorkom* (allegedly) did.[199] *Revlon*-enhanced scrutiny was unavailable because this was a stock-for-stock merger deal not involving a change of control.[200] Applying entire fairness would certainly have allowed the Court to invalidate the deal protection measures, and a case for its application could be made .[201] However, it

[199] *See* Smith v. Van Gorkom, 488 A.2d 858, 884-87 (Del. 1985).
[200] *See* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (1993); Paramount v. Time, 571 A.2d 1140 (Del. 1989).
[201] Entire fairness classically applies to controlling shareholder transactions when the controlling shareholder "stand[s] on both sides of the transaction, as in a parent-subsidiary" merger. Kahn v. Lynch Communications Systems, 638 A.2d 1110, 1115

(Del. 1994). More generally, entire fairness applies where the controlling shareholder has caused a transaction to occur and as a result "has received a benefit to the exclusion and at the expense of the" public stockholders. Sinclair Oil v. Levien, 280 A.2d 717, 720 (Del. 1971). Moreover, the Delaware Supreme Court has clearly held that a board of a controlling shareholder-corporation must protect minority stockholders. *E.g.* McMullin v. Beran, 765 A.2d at 920 and 923 (Del. 2000) ("minority stockholders must rely for protection on the fiduciary duties owed to them by the board of directors" and the board owes "minority shareholders an uncompromising duty of loyalty.") Based on this, one could construct a doctrinal argument that entire fairness should have applied in *Omnicare* because the NCS board, dominated by Outcalt and Shaw, approved the voting agreements and deal protection measures at Outcalt's and Shaw's behest. In addition, the complete lock-up deal protection measures arguably harmed the public stockholders by making it impossible for NCS to auction the company and attempt to obtain a higher price for it. *See supra* notes 219 through 239 and accompanying text for an argument that the public may have been less risk averse than Outcalt and Shaw and therefore may have preferred less onerous deal protection measures. Applying entire fairness, however, would have further raised the question of just how far a target board must go to protect the minority. For example, does the board have to adopt a poison pill to hold-off the controlling shareholders and their favored transaction? *Cf.* Mendel v. Carroll, 651 A.2d 297 (Del. Ch. 1994) (holding that under the circumstances of that case, the board of a controlling-shareholder corporation did not have a duty to issue a dilutive option to a third-party to allow that third party to consummate a transaction that would be beneficial to the public stockholders but which was opposed by the controlling shareholder). In addition, applying entire fairness in this situation would raise serious questions about how often that intrusive standard would apply to the decisions of a board of a controlling shareholder-corporation. In particular, the potential conflict of interest with respect to a complete lock-up between Outcalt and Shaw, on the one hand, and the minority stockholders on the other, is certainly less direct than the sort traditionally found to trigger entire fairness. *See, e.g.,* Sinclair, 280 A.2d at 721-22 (concluding that dividend payments paid to all stockholders but at the behest of the controlling shareholder because of its alleged need for cash did not constitute self-dealing triggering entire fairness standard). The Court was probably wise to avoid raising these issues to the extent they would have been had entire fairness applied.

Another issue the Court sidestepped was that the NCS board approved the voting agreements pursuant to Del. Gen. Corp. Law s. 203. Section 203 is Delaware's business combination statute and prevents a purchaser of control in a company from engaging in certain business combinations for a three-year period following the purchase of control. The execution of the voting agreements triggered s. 203's provisions because they transferred control within the meaning of the statute to Genesis. Section 203, however, can be waived by the target board if the waiver is obtained prior to the transfer. That is one reason why the NCS board had to approve the voting agreements. The Court could well have concluded that the waiver was itself an interested transaction triggering entire fairness. This is so because Outcalt and Shaw requested the waiver, so it was arguably a transaction between a corporation and its controlling stockholders. The Delaware Court

would also have opened up a whole can-of-worms about the duties of boards and controlling shareholders and potentially entangled the judiciary in reviewing many more transactions then it will have to under *Omnicare*.[202] In other words, entire fairness might have created more problems then it solved. By default, therefore, the Court was left with *Unocal*. Given this, perhaps *Unocal* was the best of a bad lot.

E. *Omnicare's Allocation of Decisionmaking Authority to the Court*

An important decisionmaker question facing the *Omnicare* Court was who should decide whether a completely locked-up merger agreement is appropriate. The most obvious alternative would have been to leave the decision to NCS's board and its controlling shareholders. This would have been the result of applying the business judgment rule to the complete lock-up since board actions are invariably upheld under that deferential standard. Note that leaving the decision to the board would by no means ensure that merger agreements would always be completely locked-up (although that would have been the result in *Omnicare)*. Instead, the board as decisionmaker would determine when a complete lock-up was appropriate or not. Part V.B below offers some normative reasons why leaving the decision to the board may have been inappropriate in

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of Chancery recently reached this very conclusion in In re Digex Shareholders Litigation. 799 A.2d 1176 (Del. Ch. 2000) (applying entire fairness to parent's request to partially-owned subsidiary's board for s. 203 waiver). Professors Gilson and Gordon have analyzed the complex issues this might raise, depending on how one interprets the scope of the board's duty to protect the minority. For example, is it just limited to the s. 203 waiver, or does it more generally require a target board to use all sorts of different leverage (like a poison pill) over a controlling shareholder's proposed transaction? Ronald J. Gilson and Jeffrey N. Gordon, *Controlling Controlling Shareholders*, Social Science Research Network, http://ssrn.com/abstract=417181 (June 2003), at 25-33 (analyzing In re Digex). Again, the Court (probably wisely) avoided dealing with more than it absolutely had to.

[202] *See id*.

this case.[203] For purposes of this subpart, however, the important thing is that the *Omnicare* Court plainly believed it to be inappropriate.

This conclusion is supported by the Court's decision not to apply the business judgment rule, by the way the Court applied *Unocal,* and by the Court's invalidation of the complete lock-up on independent fiduciary duty grounds. First, I will discuss the Court's application of *Unocal*. The Court applied *Unocal* enhanced scrutiny in a particularly intrusive way and concluded that a completely locked-up merger agreement would always violate *Unocal*. This is so because a completely locked-up merger agreement will necessarily run afoul of the court's definition of "coercive or preclusive." Recall that the Court concluded the complete lock-up was "coercive" because it precommitted a majority of votes to approving the merger when the agreement was signed. This made the shareholder vote a foregone conclusion and the merger a *fait accompli*.[204] Since this is the very definition of a complete lock-up, it appears that it will always violate *Unocal*.[205] By construing and applying *Unocal* this way, the Court removed the discretion to agree to a completely locked-up merger agreement from the board and the Court itself decided that such agreements should never occur. Notice that the Court did not apply *Unocal* in such a way as to police a certain type of board behavior or action (e.g., failure to fully inform itself or to use an independent committee) that might be corrected by some future board and thereby allow that future board to agree to a

[203] *See infra* notes 240 through 249 and accompanying text.
[204] Omnicare, 818 A.2d at 936.
[205] A likely exception would be where all the shareholders agree to the voting agreement, as often happens in the sale of closely held businesses with few shareholders.

completely locked-up merger agreement. The Court made the decision and the decision was "no complete lock-ups." Period.

The Court reinforced the assignment of decisionmaking authority to itself by invalidating the complete-lock up on the separate and independent ground that it was "invalid as it operate[d]" in the case.[206] The precise basis for the Court's decision is murky. The Court plainly does not like the deal protection measures, and just as plainly concludes that they violate the board's fiduciary duties because they did not contain a fiduciary-out.[207] The Court asserts that a board has "unremitting"[208] fiduciary duties owed to minority stockholders, that a board cannot "disable"[209] itself from exercising these duties, and that the deal protection measures "completely prevented the board"[210] from exercising them. But this reasoning is not so much a justification for the Court's decision to invalidate the deal protections as a retelling of its conclusion in various guises. At the end of the day, all we are left with is a close-to-naked assertion that a board's fiduciary duties require it to include a "fiduciary out" in a merger agreement that would otherwise be completely locked-up.

Although the reasoning is shaky, the function of the reasoning is more readily justified: it supports the divestiture of authority from the board on the complete lock-up issue. If there was any doubt that the target board of a public corporation might in the future try to structure a complete lock-up to avoid *Unocal*, then the Court's separate fiduciary duty invalidation shuts the door. The function of the Court's reasoning, then, is

[206]Omnicare, 818 A.2d at 936.
[207] *Id*.
[208] *Id*. at 938.
[209] *Id*.
[210] Omnicare, 818 A.2d at 936.

to reaffirm that it is engaging in a decisionmaking allocation and not in policing, and to protect the decision (i.e., "no complete lock-ups") that it made after deciding it would decide.[211] The *Omnicare* court was not a policeman disciplining the board, it was a decisionmaker calling the shots.[212]

F. *Omnicare and Shareholder Decisionmaking*

1. INTRODUCTION

The function of the *Omnicare* holding also regulates the manner in which shareholders may exercise their decisionmaking authority under the statutory merger process.[213] It thus demonstrates that corporate legal rules not only decide who decides, but how they decide. Unfortunately, although the function of the *Omnicare* ruling is defensible, the doctrinal reasoning the Court used to get there is – with all due respect – just bad. Subpart 2 explains the shortcomings in the Court's reasoning. Subpart 3 explains the function of the Court's holding.

2. CRITICISM OF COURT'S RULING

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[211] Other reasons for the Court's adoption of a clear rule are discussed in Part V.B.

[212] To appreciate more fully the nature of the decisionmaker choice that the Court made, it might be helpful to consider some alternative choices that the Court might have made. For example, the Court could have assigned itself the decisionmaker role but protected it with a more flexible standard rather than a clear rule. Perhaps the Court might have said that complete lock-ups would be upheld only if there was a "compelling justification" for one. Or, the Court could have chosen that the board remain the decisionmaker (as it is with most corporate decisions). This might have been effectuated with the application of the business judgment rule. It is important to note that this by no means would have resulted in all merger agreements being completely locked-up. Instead, the board would have exercised its discretion in determining when to lock-up a deal.

[213] For the argument that shareholders have such decisionmaking authority *see supra* notes 172 through 187 and accompanying text.

The *Omnicare* Court invalidated the deal protection measures because they were "coercive" and "preclusive" and therefore flunked *Unocal*.[214] The Court properly noted that the complete-lock up made any *ex post* shareholder vote on the merger a meaningless formality. Outcalt's and Shaw's *ex ante* irrevocable agreement to vote in favor of the merger[215] meant that it would be approved regardless of whether every other shareholder voted against the merger at the meeting. The result of the merger vote was preordained. Accordingly, the Court concluded that the complete lock-up was coercive and preclusive.

At first glance, this reasoning seems sound. As soon as the merger agreement and voting agreement which completely locked-up the deal were signed, the shareholder vote on the merger became a foregone conclusion. Surely, this must result in someone being coerced, right? Wrong. Outcalt and Shaw, controlling a majority of the votes, willingly entered voting agreements committing themselves to support the Genesis merger no matter what. Outcalt and Shaw were both sophisticated and informed. It was only Outcalt and Shaw that had to vote a particular way at the stockholder meeting. It would be an odd definition of "coercion" if compliance with their own voting agreements was labeled "coercive."

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[214]Omnicare, 818 A.2d at 934-36.

[215] At least this is the effect when coupled with the "force the vote" provision which required the board to submit the merger agreement to a shareholder vote. If the board's obligation to submit the merger agreement to a vote had been the subject of a meaningful fiduciary out, then the irrevocable voting agreements – standing alone – would not have be coercive or preclusive. This is because the board, if the conditions of the "out" were satisfied, could have terminated the merger agreement and properly refused to submit the merger agreement to a shareholder vote. Given the board's gatekeeping role in statutory mergers, this would have ended the matter unless Genesis decided then to launch a hostile bid or proxy fight.

Perhaps it was the public stockholders that were coerced by being forced to accept a merger presented to them as a *fait accompli*. But this explanation does not hold up under scrutiny either. As even the Court acknowledges, the public stockholders were free to vote however they wished.[216] It is true that their vote "wouldn't matter" in the sense that they could not outvote Outcalt and Shaw, but so what? Even absent the voting agreement they could not outvote Outcalt and Shaw. If Outcalt and Shaw voted their shares for the Genesis merger at the shareholder meeting, then Genesis would have been the merger partner regardless of how the public voted. There is nothing in the Court's opinion to suggest that this result would have been subject to challenge. Indeed, in *McMullin v. Beran*, the Court made it clear that "a majority shareholder has the right to vote its shares in favor of the third-party transaction it proposed for the board's consideration."[217] So whatever "coercion" the public stockholders felt was simply the

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[216]Omnicare, 818 A.2d at 936 (stating that although "the minority stockholders were not forced to vote for the Genesis merger, they were required to accept it because it was *a fait accompli*.")

[217] *McMullin v. Beran*, 765 A.2d 910, 919 (Del. 2000). Moreover, the Court used this fact as support for requiring the target board of a controlling shareholder to independently evaluate the value of the controlling-shareholder proposed deal and to communicate that independent evaluation to the minority stockholders so that they could make an informed decision to support the deal or exercise appraisal rights. *Id*. at 918-19, 924. *See also* Thorpe v. CERBCO, Inc., 676 A.2d 436, 444 (Del. 1996) (holding that controlling stockholders have "the statutory right as shareholders to veto" transaction they do not desire); Williams v. Geier, 671 A.2d 1368, 1380-81 (Del. 1996)(explaining that "[s]tockholders (even a controlling stockholder bloc) may properly vote in their own economic interest, and majority stockholders are not to be disenfranchised because they may reap a benefit from corporate action which is regular on its face."); Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 598 (Del. Ch. 1986) (explaining that fiduciary duties do not require "controlling shareholders sacrifice their own financial interest in the enterprise for the sake of the corporation or its minority shareholders.") Similarly, in the *Bershad* case, the Delaware Supreme Court held that a controlling stockholder has no duty "to sell its stock in a subsidiary to the highest bidder." Bershad v. Curtiss-Wright Corporation, 535 A.2d 840, 841, 845 (Del. 1987). The Court went on to explain that

unextraordinary result of being shareholders in a corporation controlled by others.[218] The deal protections did not "coerce" the public shareholders to accept the Genesis merger or "preclude" them from accepting another offer; their status as minority shareholders did.

3. A FUNCTIONAL JUSTIFICATION FOR THE COURT'S RULING

But there may be a method to the Court's madness. To see the method, one needs to consider the function of the Court's ruling. The Court's ruling can be explained as an attempt to advance shareholder wealth maximization by requiring the controlling shareholders to decide whether to vote in favor of the merger at a time when they are more likely to vote in a manner consistent with the interests of the public stockholders. That is quite a mouthful, and I will now break this contention down into several steps.

First, consider the function of the Court's invalidation of the deal protection measures, including the voting agreement by which Outcalt and Shaw (controlling a majority of the votes) agreed irrevocably to vote in favor of the Genesis merger. This ruling, in effect, prevented Outcalt and Shaw from agreeing irrevocably *ex ante* to

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"[s]tockholders in Delaware corporations have a right to control and vote their shares in their own interest. They are limited only by any fiduciary duty owed to other stockholders. It is not objectionable that their motives may be for personal profit, or determined by whim or caprice, so long as they violate no duty owed other shareholders." *Id*. at 845. *Accord* Richard A. Booth, *Minority Discounts and Control Premiums in Appraisal Proceedings,* 57 BUS. LAW. 127, 145(2001)(explaining that a "controlling stockholder has the right to control and to vote its shares in its own interest."); Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27, 32 (1999)(explaining that "courts have sanctioned the right of all shareholders to vote in their own interest . . .").

[218] *See* Stroud v. Grace, 606 A.2d 75, 83 (Del. 1992)("The fact that controlling shareholders voted in favor of the transaction is irrelevant as long as they did not breach their fiduciary duties to the minority holders.")

support the merger. Their support would have to be evidenced *ex post* at the shareholder meeting.[219]

Next, consider how the interests of Outcalt and Shaw, on the one hand, and the public stockholders on the other, might diverge with respect to a complete lock-up. At first glance, one might conclude that Outcalt and Shaw would likely act in a manner consistent with maximizing public stockholder wealth.[220] After all, Outcalt and Shaw have a large amount of their personal wealth invested in NCS shares, and they therefore would (like the public stockholders) undoubtedly have a strong incentive to sell NCS for the highest price obtainable.[221] In addition, Outcalt and Shaw have a significant enough investment in NCS to justify taking the time and gathering the information to make a correct (i.e., firm value maximizing) decision.[222] This is facilitated by the fact that they are both key senior executives and board members.

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[219] An interesting question might be the extent to which controlling shareholders might try to use Delaware s. 228 -- which permits stockholders to approve a transaction by written consent without a shareholder meeting -- to circumvent the Court's *Omnicare* decision.

[220] *See* Siegel, *supra* note 217, at 46 (noting that if "the stock is publicly traded, the controlling shareholder's self-interest can constrain its greed because if the transaction diminishes the value of the stock, the controlling shareholder will suffer proportionately.")

[221] There are ways in which Outcalt and Shaw might structure the deal to gain a larger share of the firm value for themselves. For example, they could agree to support a merger only if they received large "side payments" unavailable to the public stockholders. Such side payments might include golden parachute severance packages, consulting agreements and so forth. However, there is no evidence that such side payments were involved in *Omnicare*.

[222] Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism,* 79 GEO. L. J. 445, 466-68 (arguing that larger shareholders, "assuming their actions are consistent with their interests as shareholders, are more likely to get the answer right than are smaller shareholders" because they "will bear a larger share of the cost of an incorrect outcome" and will therefore "invest more resources in determining the value maximizing course of action.")

But a difference in interests arises once we consider the likely difference in risk aversion between Outcalt and Shaw and the public stockholders. Outcalt and Shaw, as mentioned, have a large amount of personal wealth invested in NCS. If NCS goes bankrupt, if its equity becomes worthless, or if it is forced to sell itself on the cheap, then Outcalt and Shaw will lose a substantial amount of personal wealth. Accordingly, they will quite likely be risk averse with respect to their investment in NCS.[223] They therefore may well be more inclined to go with a "sure thing" deal such as the one offered by Genesis over a riskier – but potentially more lucrative – strategy of initiating a bidding war between Genesis and Omnicare. Such a strategy would be riskier in this case because Genesis had made it clear that it would not serve as a "stalking horse" and would not negotiate with NCS if it thought that a bidding war with Omnicare would result. Indeed, that is the very reason Genesis demanded the deal protection measures. If NCS nonetheless demanded an auction, then Genesis might have withdrawn completely and Omnicare would have been free to pursue its strategy of buying NCS on the cheap. On the other hand, if the risk of demanding an auction paid off, then NCS would reap the reward of the higher prices typically associated with auction sales. But there is no guarantee that the riskier course of action would pay-off. Being risk averse, Outcalt and Shaw may well not want to take the chance.

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[223] Even if Outcalt and Shaw are not more risk averse than NCS's public stockholders, the rule the Court crafts will apply to all controlling shareholder voting lock-ups and in general, it is reasonable to expect that controlling shareholders will almost invariably have a larger proportion of their personal wealth tied-up in the company than the company's public stockholders. Like managers, therefore, controlling shareholders will likely be more risk averse than the public stockholders. *See* Easterbrook & Fischel, *supra* note 13, at 29-30 (explaining that managers will be risk averse because they have a large amount of personal wealth tied-up in the company).

Put differently, Outcalt and Shaw are exposed to substantial firm-specific, or "unsystematic" risk. Professor Henry Hu explains that "'unsystematic risk' arises from the perils peculiar to the business of an individual company."[224] The "unsystematic risk" that Outcalt and Shaw face is that refusing to grant a complete lock-up may cause Genesis to walk away and leave Omnicare to acquire NCS for a lower price. Because of this substantial "unsystematic risk," and because of their risk aversion[225], Outcalt and Shaw are relatively more likely to want the sure thing (the Genesis deal) and relatively more likely to agree to deal protection measures to get it.[226]

Relative to whom? Relative to the public stockholders. The public is likely to be much less risk averse than Outcalt and Shaw. This is because the public either is (or can easily become) well diversified.[227] That is to say, NCS will only be a small part of each

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[224] Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1307 (hereinafter *New Financial Products*).

[225] Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 442 (1998) (stating that "[i]n short, an undiversified stockholder is risk-averse.")

[226] This issue can be looked in a slightly different, but complimentary, way: Outcalt and Shaw own only 20% of the equity but control over 60% of the votes. Accordingly, they will not receive shares of the gains (or losses) from a sale of NCS commensurate with their control. They therefore do not have the incentives to make optimal decisions. They will reap only 20% of the value of any improvement in the sale price, and therefore their incentive to take steps to improve that price is only 1/5 of the value of such steps. In other words, they will invest too little in steps to improve the sale price. Easterbrook & Fischel, *supra* note 13, at 73-74 (making this argument in general about the suboptimal incentives of those with voting control disproportionate to their ownership interest).

[227] *See* Gilson & Gordon, *supra* note 201, at 33-34 n. 67 (noting that the public shareholders are diversified and therefore risk neutral but that the controlling stockholders are undiversified and therefore risk averse); *cf.* Rock, *supra* note 227, at 466-68; *see also* Easterbrook & Fischel, *supra* note 13, at 122 (explaining that "[d]iversification is available at remarkably low cost . . . Investors with little personal wealth can diversify by purchasing shares of mutual funds, which hold representative samples of stocks, mortgages, and many other investment vehicles.") *Cf.* Henry T.C. Hu,

public stockholder's well diversified portfolio. Such a portfolio allows the public to diversify-away the NCS (and other) firm-specific, unsystematic, risk so worrisome to Outcalt and Shaw.[228] Accordingly, the public stockholders[229] will prefer that each of the

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Buffett, Corporate Objectives, and the Nature of Sheep, 19 CARDOZO L. REV. 379, 393 (1997) (hereinafter *Buffet*) (noting that legendary investor Warren Buffett and his company, Berkshire Hathaway, "assume[] an ill-diversified shareholder – a decision that is probably contrary to the usual assumption of most publicly held corporations.")

[228] *See, e.g.*, Hu, *New Financial Products, supra* note 224, at 1307 (explaining that "investors can substantially eliminate their exposure to unsystematic risk through the simple expedient of buying a large enough number of stocks; by buying such a large number of stocks, the investor is basically left facing only systematic risk."); *see also* Easterbrook & Fischel, *supra* note 13, at 29 (explaining that a "[h]olding a basket of equities enables the investors to realize these expected returns, free from firm-specific risk (whether the risk of the firm's business ventures or of managers' dishonesty).") Instead, the diversified public stockholders will worry only about "systematic risk," which is risk arising "from economy-wide perils that threaten all businesses." *E.g.*, Hu, *New Financial Products*, *supra* note 224, at 1307. An example of systematic risk might be a change in interest rates, an oil embargo, and so forth.

[229] There is an important assumption built into this understanding of the diversification of public stockholders. The assumption is that we are concerned only with target stockholders and that we ignore the possibility that target stockholders are well-diversified across potential buyers and sellers. *See* Easterbrook & Fischel, *supra* note 13, at 120-24 (arguing that one should assume just the opposite, i.e., that stockholders own diversified portfolios of buyers and targets). If stockholders were diversified across buyers and sellers, then one could argue that they are indifferent about the purchase price paid in an acquisition and instead would want only that value enhancing acquisitions occur with as few transaction costs as possible. This is so because any decrease in value of a seller's stock who sold "too cheaply" would be offset by an increase in the value of the buyer's stock who got a "deal." The stockholder owning shares in both would not care how the gain were allocated between the two. *Id*. at 28-29, 120-24, 189.

The Delaware Courts have quite clearly adopted the assumption that boards should focus only on target stockholder welfare and should not assume that target stockholders are indifferent about how the gain between buyer and seller are allocated. For example, it is blackletter law that "in the context of an entire sale . . . the directors must focus on one primary objective – to secure the transaction offering the best value reasonably available for all stockholders." *McMullin v. Beran*, 765 A.2d 910, 918 (Del. 2000); *see also* Revlon v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1985) (same). There is no question but that the "stockholders" referred to are the target company's stockholders – the only stockholders to whom the target board owes a fiduciary duty. Similarly, the Delaware Supreme Court has specifically rejected the "passivity thesis" advanced by Easterbrook and Fischel, a part of the basis for which was

companies in their portfolios (including NCS) pursue a riskier strategy over a safer strategy so long as the expected value[230] of that riskier strategy is greater than the expected value of the less risky one.[231] Put differently, over time and on average, a portfolio of companies pursuing the higher expected value riskier strategies will be more

described in the preceding paragraph. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 n. 10 (1985)(stating that Eaterbrook's and Fischel's passivity thesis "clearly is not the law of Delaware, and . . . it has not been adopted either by courts or state legislatures.") For scholarly critique of the "passivity thesis" *see, e.g.,* David D. Haddock, Jonathan R. Macey, Fred S. McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987); Dale A. Oesterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53 (1985); Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Gilson, *A Structural Approach, supra* note 13, 868-75.

[230] The "expected value" of a project is the weighted average of possible outcomes. *E.g.,* Booth, *Stockholders, supra* note 225, at 441.

[231] *See* Hu, *New Financial Products*, *supra* note 224, at 1281-82 (explaining that "modern financial theory suggests that corporations concerned about the well-being of shareholders will generally take more risks than corporations concerned about the entity's own well-being; shareholder can, by holding a portfolio of stocks, diversify away much of the risk that a corporation might itself find daunting."); *see also* Booth, *Stockholders*, *supra* note 225, at 441 (explaining that "a diversified investor may favor risky business strategies – even if such strategies entail the possible ruin of the company – provided the expected return (the weighted average of possible outcomes) is great enough to justify the risk."); a*ccord* Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 U.C.L.A. L. REV. 277, 295, 299-300 (1990) (hereinafter *Fiduciary Principles)* (explaining that shareholders "regardless of their individual risk preferences, generally would want managers instead to focus primarily on nondiversifiable risk in evaluating corporate investment opportunities" and that "to maximize shareholder wealth in an idealized world, as a first cut, a corporation must . . . focus primarily on systematic risk.") The risk that a particular deal will fall-through if a complete lock-up is not granted is diversifiable to the extent that over time and across all companies in a diversified portfolio, pursuing the riskier, no-complete lock-up, alternative has a higher expected value and therefore will lead to a higher average price. In other words, the risk that a given company's decision to decline to grant a complete lock-up could lead to a loss of a deal is unsystematic.

valuable than a portfolio of companies pursuing lower expected value and less risky projects.[232]

The foregoing argument is reflected in one of the classic justifications for the business judgment rule. It is often argued that the business judgment rule encourages efficient risk taking because it insulates board members from being second-guessed and held liable for business decisions undertaken in good faith but that turn out badly. This allows the board to pursue riskier but more valuable projects that they otherwise might not prefer if they were personally at risk whenever a project failed.[233] The result is that overall corporate, and with it stockholder, wealth is maximized.[234]

The upshot is that the public stockholders will be much more likely than Outcalt and Shaw to prefer the riskier (but potentially more lucrative) strategy of refusing to agree to a complete lock-up with Genesis and demanding a bidding war with Omnicare.[235] In sum, the interests of Outcalt and Shaw and the public stockholders do

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232 *See, e.g.,* Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1074 (1996) (stating that "[d]iversification, then, under the right circumstances, allows the investors to live at the average without regard to dispersion."); *accord* Easterbrook & Fischel, *supra* note 13, at 98 (explaining that a "decision is good to the extent is has a high *expected* value, although it may also have a high variance.")

233 This is a summary of the argument contained in Joy v. North, 692 F.2d 880, 886 (2nd Cir. 1982). That opinion was written by former Yale corporate law professor Ralph Winter. Judge Winter argued that it was in the interest of shareholders for the law not to create incentives for overly cautious business decisions. This is because "[s]ome opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit." *Id*. He noted that shareholders could easily reduce their volatility risk by diversifying and that therefore the riskier projects on the might be better because "great losses in some stocks will over time be offset by even greater gains in others." *Id*.

234 *See* Easterbrook & Fischel, *supra* note 13, at 99-100 (making this argument).

235 *See* Booth, *Stockholders*, *supra* note 225, at 442 (stating that in "the context of takeovers, this attitude [of risk preferring diversified stockholders] no doubt translates

differ in one important respect: risk aversion.[236] And that risk aversion is implicated by the deal protection measures at the very heart of *Omnicare*.

At this point, the method to the Court's madness starts to emerge. By precluding Outcalt and Shaw from deciding *ex ante* to support the merger, and forcing them to decide at the shareholder meeting, the Court ruling tends to harmonize the preferences of Outcalt and Shaw with those of the public stockholders. This is because at the time of the shareholder meeting, the bidding war has already occurred (or failed to occur), and Outcalt and Shaw and the public stockholders will face only a decision on which they are much more likely to agree: which offer on the table (assuming there is more than one) is better. It is true that the controlling shareholders will still be able to outvote the public if they so choose. But at least one important difference in interests – their comparative risk aversion with respect a completely locked up deal[237] -- has been eliminated. In sum, the Court's rule preserves the shareholders' negative control right in statutory mergers, but regulates it in such a way as to promote stockholder wealth maximization. Viewed in this way, the Court's decision (while not unassailable[238]) makes sense.[239]

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into a preference for a freewheeling market for corporate control among well-diversified investors.")

[236] *See* Booth, *Stockholders, supra* note 225, at 434 (noting the conflict between diversified and undiversified investors and that the former are likely to be less risk averse than the latter); *see also* Hu, *Fiduciary Principles*, *supra* note 231, at 366 (noting that a "clear conflict of interest exists between shareholders, who cannot avoid being inadequately diversified, and diversified shareholders.")

[237] Deal protection measures that do not completely lock-up a deal are different and less problematic because they do not foreclose the stockholders from accepting a higher bid that emerges after the board's preferred deal is announced. *E.g.*, Hanewicz, *supra* note 4, at 247-53.

[238] *See infra* notes 265 through 285 and accompanying text. In addition, the implications of making decisions based on the assumption of diversified stockholders itself raises many complex questions. Professor Richard Booth, for example, has argued that

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fiduciary duties should be construed to apply to undiversified stockholders and not to diversified stockholders. Booth, *Stockholders, supra* note 225. Among other things, he argues that a duty to diversified shareholders would be unworkable because it would be difficult and costly for management to determine what sort of diversified shareholders it was dealing with, what their portfolio strategies were, and how a myriad of business decisions would impact a diversified portfolio. *Id.* at 447-450. He also argues that diversified shareholders would rather management act as though they were undiversified. *Id*. at 451-54.

I offer three responses to Professor Booth's argument. First, my task in this Article is not to normatively defend the Court's *Omnicare* decision. Instead, it is to attempt to make sense of that decision. The argument put forward in this section does so, and does premised on a notion of maximizing diversified stockholder wealth that even Professor Booth acknowledges is widely shared. *Id*. at 434-35 (noting that "[m]ost scholars who favor stockholder wealth as the measure of management duty have quite naturally assumed that management should manage with the interests of diversified stockholders in mind because rational investors diversify.") Second, the Court's *Omnicare* decision is narrow and does not necessarily mean that a board must now make all business decisions with a diversified stockholder base in mind. Instead, it applies only to the narrow context of a statutory merger with a complete lock-up (although some of its implications may admittedly be broader). This somewhat mitigates Professor Booth's reasonable concerns about "workability." Third, Professor Booth may well not be so critical of using the diversified shareholder as a benchmark in the way I suggest here. He argues that in the context of a sale of the business, diversified stockholders ought to be able to sue for "negligent mismanagement" to prevent target managements from systematically selling at prices which are too low on average. *Id*. at 472-73. He suggests that diversified stockholders would instead prefer a riskier strategy of hard bargaining to obtain the highest price possible and that they should be able to sue managers who negligently fail to implement such a strategy. *Id*. at 472-73. This is consistent with the interpretation I have proposed in this Section. For another analysis of the problems associated with defining the shareholder as diversified or undiversified, *see* Greenwood, *supra* note 232. Professor Henry Hu has also written extensively on the topic. *See* Hu, *New Financial Products*, *supra* note 224; Hu, *Buffet*, *supra* note 227; Hu, *Fiduciary Principles*, *supra* note 231.

[239] Given this analysis, one might legitimately ask whether any deal protection measures should be permitted since they reduce the risk that a deal will be lost and therefore are, at least at the margin, more likely to be preferred by controlling stockholders than public stockholders. There is an important difference in degree, however, between the complete lock-up at issue in *Unocal* and less restrictive deal protection measures. Less restrictive ones still provide the opportunity for the shareholders to accept a higher bid and since by definition they do not completely tie-up a majority of votes, then at least a majority of votes will be "free" to consider such a higher bid at the stockholders meeting, i.e., at a time when the stockholders as a whole will be more likely to have the same risk preference. Such deal protection measures are therefore less objectionable.

My contention in this Part IV has been that the functional significance of corporate legal rules is to allocate decision decisionmaking authority to various institutions, including the shareholders, the courts and the board. This is in direct conflict with the fundamental premise of director primacy that decisionmaking is vested in the board and not those other institutions. This part has argued that the functional significance of legal rules is demonstrated by an examination of the business judgment rule and entire fairness standards of review, by the statutory merger approval process, by *Omnicare*'s interpretation of *Unocal*, and by the function of *Omnicare*'s holdings.

V. A PRELIMINARY NORMATIVE EVALUATION OF OMNICARE

A. *Introduction*

A comprehensive normative analysis of *Omnicare* is beyond the scope of this Article. Instead, I have used *Omnicare* to establish that the function of legal rules is to allocate decisionmaking authority and to critique director primacy. Nonetheless, this Part discusses the most important aspects of the *Omnicare* decision that should be considered when normatively evaluating the opinion, and provides some preliminary analysis of them. Much of this analysis is driven by the understanding that corporate legal rules function to allocate decisionmaking authority. Subpart B makes the case for the *Omnincare* Court's allocation of decisionmaking authority to itself with respect to complete lock-ups. Subpart C then considers some important normative problems with the Court's decision.

B. *The Case for the Court's Decision*

The starting point for a normative analysis is to evaluate the choice the *Omnicare* Court made to allocate decisionmaking authority to itself with respect to complete lock-ups. In turn, this evaluation depends on whether the Court is the institution best suited to making a decision that will advance the ultimate goal of corporate law – again, for purposes of this Article, I assume that this is maximizing shareholder welfare. Other possible decisionmaking institutions include the board, the controlling shareholders, and the public shareholders. As discussed below, each of these other institutions has a significant flaw that suggests they are unlikely to be the best decisionmaker under the circumstances.

The biggest problem with assigning the decisionmaking task to the board in *Omnicare* is that it will naturally tend to favor the course of action that the controlling stockholders (Outcalt and Shaw) prefer.[240] The controlling stockholders themselves constituted one-half of the NCS board[241], and were likely responsible for appointing the other two NCS independent board members. It would be unusual if there was not a natural affinity and respect between the independent board members and the controlling stockholders in these circumstances. Even more skeptical independent board members would naturally be inclined to favor the course of action preferred by the controlling stockholders under the facts of *Omnicare*. NCS was being sold, and Outcalt and Shaw owned a lot of shares and therefore had a strong incentive to act in the public stockholders' interests by selling the company for highest price possible. This is

[240] *See* Bainbridge, *Convergence Debate*, *supra* note 8, at 57-58 (noting that if "the board becomes beholden to the interests of large shareholders, it may become less concerned with the welfare of smaller investors" and that "the interests of large and small investors often differ.")
[241] Omnicare, 818 A.2d at 919.

especially true since the form of the transaction at issue was one in which the public stockholders were to receive the same per share consideration as the controlling stockholders. Outcalt and Shaw did not attempt to structure the transaction in such a way that would allow them to aggregate a disproportionate share of the merger consideration to themselves. Nor was this an attempt to "freeze-out" the minority stockholders at an inappropriately low price, or a classic self-dealing transaction in which controlling shareholders try to sell something to the corporation at an artificially high price or buy something from it at an artificially low price.[242] Put differently, the independent members of the board did not have any of the traditional "red flags" that suggested they should distrust the judgment of Outcalt and Shaw. Given all this, it is no surprise that the independent members of the board were in accord with Outcalt and Shaw.

It is important to note that I am not suggesting that the board acted or was inclined to act with any improper motive.[243] Indeed, the actions it took appear to be exemplary in

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[242] For a good discussion of the ways in which controlling shareholders can take advantage of minority shareholders *see* Gilson & Gordon, *supra* note 201 (explaining that "a controlling shareholder may extract private benefits of control in one of three ways: by taking a disproportionate amount of the corporation's ongoing earnings; by freezing out the minority; or by selling control.")

[243] This illustrates another difference (albeit a subtle one) between my analysis and director primacy. Director primacy views *Unocal* as primarily a policing tool for policing conflicts of interest and views "motive" as the most relevant factor. However, under my analysis motive is not dispositive factor. The board is *Omnicare* was naturally inclined to agree with the controlling stockholders, but this was not necessarily because of any bad motive. In fact, as discussed above, it seems like the independent board members (and the controlling stockholders) had nothing but the best of motives. But in my analysis that does not matter. What matters is that the institutional bias of the board in this situation is a drawback of assigning it decisionmaking authority. Similarly, the "omnipresent specter" of *Unocal* is not, I believe, primarily a motive based inquiry. It is, rather, an inquiry into whether board is in the best position to decide about defensive measures. The term "omnipresent specter" itself speaks of the possibility of a conflict-of-interest, not the presence of actual bad faith. Again, it is the institutional biases inherent in defending

many respects. It hired an investment banker to shop NCS, and replaced that investment banker in an attempt to generate more interest in the company.[244] The board negotiated hard with Genesis and agreed to Genesis' demand for the complete lock-up only after Genesis credibly threatened to withdraw its proposed transaction.[245] The board was reasonably concerned that if it did not agree to the measures, it would lose the then-superior Genesis offer and be left only with Omnicare's lowball offer.[246] Nor was there any hint of improper side-payments offered to NCS or its managers as an inducement to accept the Genesis proposal. The board's problem was not bad motive, it was its structural proclivity to adopt a course of action desired by the controlling stockholders.

And, as discussed above,[247] there is a problem with leaving the decision to the controlling stockholders (or to those likely to agree with them). It is true that Outcalt and Shaw had the information and high-stakes necessary to make an informed and deliberate decision about the appropriate level of deal protection. But, as argued in Part IV, they were likely to be too risk averse.[248] Nor were the public stockholders in any position to

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against hostile takeovers that triggers enhanced scrutiny. Given that their jobs are on the line and given that a hostile takeover often implies that they have not done a good job managing, it is no surprise that target managers and board members are naturally inclined to want to defend against a hostile takeover. The *Omnicare* court's explanation of *Unocal* as a decisionmaker conflict places virtually no weight on motive. Of course, if bad motive is demonstrated, this is certainly a powerful reason not to trust the board. My point is only that enhanced scrutiny is not primarily concerned with it.

[244] Omnicare, 818 A.2d at 920-21.

[245] Omnicare, 818 A.2d at 921-27.

[246] Omnicare, 818 A.2d at 923. One of the independent NCS directors testified that it was his understanding that Genesis "wanted to have a pretty much bulletproof deal or they were not going to go forward." *Id*.

[247] *See supra* notes 219 through 239 and accompanying text.

[248] *See supra* notes 219 through 239 and accompanying text.

decide whether NCS should agree to a completely locked-up deal. They face too many well-known collective action problems for that.

All these factors mitigate in favor of the Court assigning to itself -- as a decisionmaker of last-resort -- the question of when, if ever, a merger should be completely locked-up.[249] This is not to suggest that the Court is the perfect decisionmaker either. Numerous well-known weaknesses plague judicial review of business decisions.[250] Among other things, a court has a natural tendency to view things with the benefit of hindsight and to fail to appreciate how the situation appeared at the time the board made its decision. Judicial review that is too intrusive may also make directors too risk averse and discourage efficient risk taking, at least if the judicial review leads to the imposition of money damages.[251] The judiciary's resources are also limited. There are not enough judges[252] to second-guess the vast majority of business decisions – even the vast majority of really important business decisions. Also, any rule that a judge crafts will have serious shortcomings because of the complexity of the business world. A rule that seems to make

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[249] Note that I say "mitigate in favor" of the Court. A complete analysis would again require a more in-depth analysis of all the costs and benefits of assigning the decision to the various institutions, and a comparison based on that analysis. Here, I sketch out only a few of the more important considerations.

[250] *See* Hanewicz*, supra* note 4, at 253-57; *accord* Joy v. North, 692 F.2d 880, 886 (2nd Cir. 1982) (noting that "courts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions" and that "a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.")

[251] Joy v. North, 692 F.2d 880, 886 (2nd Cir. 1982).

[252] At least given the judiciary's role currently accepted role in the business world. One could argue for a dramatically expanded, more regulatory, role for the judiciary or some other institution in which more business decisions were reviewed. Such regulatory institutions exist, for example, to one degree or another in many regulated industries such as public utilities. I certainly do not argue for such a regulatory role, but merely suggest it as one option.

sense given the facts of a particular case may be quite inappropriate for (although technically binding on) the next case. The Court was therefore not the perfect decisionmaker but, like the Court's decision to apply *Unocal*, it may have been the best of a bad lot.

The *Omnicare* decision itself reflects the Court's perception of some of these weaknesses because it announced a rule -- no complete lock-ups – that was both clear and narrow. The clarity of the rule should limit the judicial burden going forward of enforcing it. After *Omnicare*, one would not expect a slew of new cases dealing with the propriety of a completely locked-up merger deal. Instead, the Court provided clear guidance to planners. Quite the opposite would likely have occurred if, for example, the Court upheld or invalidated the measures based on more flexible "reasonableness" grounds. This would predictably have led to numerous cases designed to test the contours of "reasonable" deal protection measures. With respect to complete lock-ups, at least, no such thing should occur.

There are, of course, drawbacks to such a clear rule. It is the nature of clear rules to sweep too broadly, and there are no doubt situations in which complete lock-ups will benefit target shareholders.[253] To limit the sweep of its decision, the Court also made its rule narrow, at least with respect to the application of *Unocal*.[254] Its ban applies only to complete lock-ups, and not to the whole host of other types of deal protection

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[253] For example, the expected value of completely locking-up a given transaction may exceed the expected value of continuing to try to hold an auction.
[254] For an evaluation of its "authority" ruling *see infra* notes 206 through 212 and accompanying text.

measures.[255] It is true that such other deal protection measures will now get enhanced scrutiny,[256] but the Court left itself lots of leeway to shutdown judicial review of such measures if it becomes too intrusive. Indeed, the *Omnicare* Court's application of *Unocal* may deter intrusive judicial review of such measures in the first place. This is because the Court reaffirmed the narrow reading go of *Unocal* contained in the Court's 1995 *Unitrin* decision.[257] *Unocal* purports to require that defensive measures be "reasonable."[258] Such a reasonableness inquiry, if taken seriously, could involve substantive judicial review of defensive measures.[259] However, in *Unitrin* the Court interpreted this "reasonableness" prong narrowly to prohibit only those measures that are "coercive" or "preclusive."[260] In turn, "coercive" and "preclusive" were defined to mean only those measures which "force" an action on the shareholders, or "deprives" them of the right to receive tender offers or "precludes" a bidder from engaging in a proxy contest.[261] A mere impediment to other bidders has historically not been enough.[262] Something more, much more, is required. Indeed, in a recent study Professors Thompson and Smith found that *Unocal*

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[255] These include stock lock-ups, asset lock-ups, termination fees, and no-shops, among others.
[256] Prior to *Omnicare*, this was the subject of debate. *See, e.g.*, Hanewicz, *supra* note 4.
[257]Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995).
[258] Unocal, 493 A.2d at 955.
[259] *See* Ronald J. Gilson and Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989).
[260]Unitrin, 651 A.2d at 1387.
[261]*Id*.
[262] *E.g.*, IXC Communications, Inc. S'holders Litig., 1999 WL 1009174, *8 (Del. Ch. Oct. 27, 1999) (concluding that voting lock-ups which covered over 40% of eligible votes were not "preclusive or coercive" because 60% of the voters were free to reject the transaction. The court noted that the voting agreements made the deal "*almost"* locked up, and that the remaining shareholders had "*scant"* power to reject it, but that "*almost* locked up does not mean "locked up" and that "scant power" does not mean "no power.")

has been used to invalidate board actdions so infrequently that it has become a doctrinal "dead letter."[263]

Omnicare may well be the exception that proves this rule. In *Omnicare* there was absolutely no chance for the shareholders to vote down the merger at the meeting. Few deal protection measures are so strong. Invocation of the business judgment rule would have resulted in an almost complete ban on judicial second guessing of deal protection measures.[264] The *Omnicare* Court declined to go quite that far, but its holding is hardly a signal for a judicial free-for-all. At most, the *Omnicare* decision is a signal that the Court might, just might, under some circumstances, be interested in taking a closer look deal protection measures that are not complete lock-ups. But given the Court's history of applying *Unocal*, and given its affirmance of *Unitrin*'s restrictive interpretation of *Unocal*, those circumstances may be quite narrow. In sum, there are legitimate reasons for the decisionmaker choice that the Court made in *Omnicare*, and the contours of the Court's rule reflect sensitivity to its own shortcomings as decisionmaker.

C. *Problems with the Court's Decision*

All this is not to suggest that the Court's decision was normatively uncontroversial. Indeed, there are (at least) several important potential problems with the Court's decisionmaker choice. First, the Court seemed to ignore the fact that NCS's public stockholders purchased their stock knowing that NCS's dual class common stock structure gave Outcalt and Shaw control despite the fact that they did not own a majority

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[263] Thompson and Smith, *supra* note 13, at 286.
[264] Elsewhere, I have argued that this would have been precisely the right result with respect to no-shops. *See* Hanewicz, *supra* note 4.

of NCS's equity.[265] Dual-class stock has, of course, a long and controversial history. But the debate over dual-class stock has centered around the scenario in which the managers of a firm exploit public stockholder collective action problems to recapitalize from a single class to a dual class common stock in such a way as to "coerce" the public stockholders into ceding effective control of the firm to the managers.[266] This is often done as an anti-takeover measure.[267] In *Omnicare*, however, there can be no such objection since the dual class of common stock was in place at the time of NCS's initial public offering.[268] The common stockholders freely chose to purchase the shares

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[265]Omnicare, 818 A.2d at 918-19.

[266]For critiques and analyses of such "dual-class recapitalizations" *see, e.g.,* Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807 (1987); Jeffrey N. Gordon, *Ties that Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1 (1988).

[267] Gordon, *supra* note 266, at 4 (stating that "[i]t is no secret that the current popularity of dual class common among public firms is a response to the recent wave of takeovers.")

[268] *See, e.g.,* Richard A. Booth, *Minority Discounts and Control Premiums in Appraisal Proceedings,* 57 BUS. LAW. 127, 147-48 (2001)(concluding that there is no prohibition on dual-class IPOs and that "if the market does not want to buy into an IPO in which the controlling stockholders decline to give up any control, presumably it will not do so and the offering will fail. In other words, this is an area in which we can confidently let the market decide."); Gilson, *supra* note 266, at 808-09 (explaining that "an initial public offering by a company with a capital structure containing dual class common stock – . . . should not be controversial at all . . . A stock's limited voting rights are reflected in a reduced price, so that the company's owners at the time it goes public, and not the purchasers, bear the cost."); Gordon, *supra* note 266, at 4-5 and 10 (stating that "[o]ne crucial difference for firms now seeking to adopt the dual class common structure is that the required corporate action is a recapitalization, rather than an initial public offering" and that a dual-class initial public offering "does not require justification on shareholder wealth maximization grounds, because the purchasing shareholders will be compensated for the costs associated with a dual class structure by an appropriate discount in the share price.") *See also* Douglas C. Ashton, *Revisiting Dual-Class Stock*, 68 ST. JOHNS L. REV. 863, 876 (explaining that dual-class stock "that is distributed by way of an IPO, or through a stock dividend to existing shareholders, is generally not considered disenfranchising. Thus its use is viewed less skeptically . . ."). Dual class stock is a common tool that founding entrepreneurs can use to raise capital through the equity markets while at the same time retaining control over the corporation. By putting such

nonetheless; they knew or should have known that the dual class structure gave Outcalt and Shaw control. In other words, the public shareholders arguably voted with their pocketbooks to allow Outcalt and Shaw to decide whether to completely lock-up a merger deal, along with virtually every other important corporate decision.[269]

The question then becomes, is there any reason not to respect that choice? Typically, shareholders and others are held to bargains they freely and knowingly make. Freedom of contract and adhering to one's bargain are important central tenets of American law. But there is a literature suggesting that some terms in a company's certificate of incorporation (where the dual class terms would be) in initial public offerings are not adequately priced and that there are imperfections in the initial public offering process.[270] If so, this would support judicial intervention to protect the public stockholders even though they "freely" purchased their NCS stock with notice of the dual-class structure. Resolving the debate about the extent to which certificate terms are adequately priced in IPOs is beyond the scope of this Article.[271]

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restrictions in place prior to the initial public offering, the founding firm members also bear the cost of selling the public shares in a company that is privately controlled. *E.g., id.* at 884. At least, this is true if the markets are efficient enough to price such dual-class capital structures. Gordon, *supra* note 266, at 10-11 n. 23.

[269] *See* Gordon, *supra* note 266, at 20 (noting that the public's loss of control associated with dual-class initial public offerings is "presumably reflected in the price that outsiders pay for shares.")

[270] *See* Bebchuk, *The Case Against Board Veto, supra* note 192, at 1016 and sources cited therein ("Researchers . . . have raised the possibility that the adoption of such charter provisions resulted from imperfections in the IPO process.")

[271] Interestingly, the validity Outcalt's and Shaw's exercise of disproportionate voting rights under the dual class structure was implicated in the *Omnicare* litigation. The public stockholders claimed that by the terms NCS's certificate, Outcalt's and Shaw's "super-voting" stock converted to single vote stock when they entered into the voting agreement. If that conversion had occurred, then Outcalt and Shaw would not have had a controlling share of the votes. The public stockholders would have. The Court of Chancery rejected

There is another possible response to the argument that the public stockholders' purchase of dual-class shares constituted their agreement to cede control over complete lock-ups, and everything else, to Outcalt and Shaw. As the *Omnicare* Court made clear, a board has fiduciary duties to the public minority stockholders. The public, therefore, may have reasonably expected to be protected by these fiduciary duties even though Outcalt and Shaw would have voting control. If so, the price the public paid would have reflected this and it would not be inappropriate to give them the benefit of their bargain by awarding them relief later when NCS's board violated its fiduciary duties. Things get particularly messy as this analysis proceeds, however, because fiduciary duties are notoriously vague and context specific. This would make it difficult for the public to argue, for example, that they thought they were buying fiduciary duties that specifically prohibited the board from agreeing to a complete lock-up. Indeed, the precise contours of a board's fiduciary duties to public stockholders in corporation with a controlling shareholder is one of the most vexing facing practitioners, courts, and commentators alike.

Aside from the question of whether the public stockholders agreed, one must also consider the costs to the public stockholders of preventing controlling stockholders from having the authority to completely lock-up a deal. Such authority has value, if for no other reason than that it permits the controlling stockholder to agree to merge the company in such a way as to satisfy its risk aversion preference. Denying this authority

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this claim. Omnicare, Inc. v. NCS Healthcare, Inc., 2002 WL 31445163 (Del. Ch. Oct. 29, 2002). The Supreme Court did not really reach this claim, and instead held simply that the Court of Chancery's decision on it was reversed "to the extent that decision permits implementation of the Voting Agreements contrary" to the Court's ruling on the fiduciary duty claims discussed in this Article. Omnicare, 818 A.2d at 939.

makes it less valuable to be a controlling shareholder and can be expected to marginally decrease the incentive to become one. This would hurt public stockholders because the presence of a controlling shareholder in a company can benefit that company's public stockholders. The presence of a controlling shareholder reduces managerial agency costs because the controlling shareholder typically has the information and high-stakes necessary to closely monitor management to ensure that management does not shirk and thereby destroy or appropriate firm (and shareholder) value.[272]

Similarly, there are undoubtedly instances in which the higher expected value option is to completely lock-up the deal on the table and not risk losing it in the hopes that another deal will emerge. For example, it could very well be that the target board and controlling shareholder are confident (and correct) that the offer on the table is the most valuable one that will emerge. Perhaps the offer is from a buyer that for tax or other reasons will value the seller more highly than any other possible buyer, or perhaps the target has already canvassed the market and is confident that it is dealing with the highest valuing buyer.[273] In such instances (among others), the target should be able to extract more value for its public shareholders if it is allowed to irrevocably bind the target to the transaction with that buyer via a completely lock-up deal. This ability to "pre-commit" has value to the buyer (like Genesis), who may be worried that a subsequent bidder (like Omincare) will emerge to break-up the deal and "steal" the target. The first buyer should

[272] *See* Gilson & Gordon, *supra* note 201, at pp. 2-3.
[273] *See, e.g.* Barkan v. Amsted Industries, 567 A.2d 1279, 1287-88 (Del. 1989) (concluding that the target board in that case "had valid reasons for believing that no rival bidder would be able to surpass the price" offered by the management-buyout group, and that these reasons included "significant tax advantages" that would be available to the group but not to others because of the presence of an employee stock ownership plan).

be willing to pay extra for the extra protection a complete lock-up offers.[274] By precluding the complete lock-up pre-commitment strategy, the Court prevents the public from reaping the gains associated with it.[275]

Relatedly, one needs to consider the effect that prohibiting such pre-commitment strategies would have on the incentive for potential buyers to search for targets in the first place. Bidders, like Genesis, incur substantial costs in locating and evaluating potential targets. To the extent they are unable to acquire a target they locate because of an inability to completely lock-up the deal, they may be unwilling to incur as much search costs in the future.[276] At the margin, this could reduce search and reduce the number of value enhancing transactions. This problem is at least partially mitigated by the fact that targets are still free to offer reasonable termination fees to buyers to compensate them – at least in part – if a subsequent bidder emerges and breaks-up the first deal.[277] Nonetheless, such fees may not adequately compensate the first buyer who may well view the target as unique and consider its loss as uncompensable in money damages.[278]

Similarly, one must consider whether the costs of denying controlling shareholders the ability to completely lock-up a deal outweigh the benefits to public as a

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[274] *E.g.*, Hanewicz, *supra* note 4, at 230-33. On the other hand, one would need to consider how well a reviewing Court could distinguish between higher-expected value lock-ups and lower expected value lock-ups. It could be that the costs of trying to make such distinctions (including the risk of error) outweigh the benefits.
[275] For further argument about the benefits of such precommitment strategy *see* Stephen M. Bainbridge, *Dead Hand and No Hand Pills: Precommitment Strategies in Corporate Law*, http://papers.ssrn.com/abstract=347089 (August, 2003).
[276] *See, e.g.,* Easterbrook and Fischel, *Responding to Tender Offers*, *supra* note 8, at 1178-79,
[277] *See, e.g.*, Brazen v. Bell, 695 A.2d 43 (Del. 1997) (upholding termination fees using a liquidated damages analysis).
[278] Hanewicz, *supra* note 4, at 231 n. 207.

whole gained by such a denial. If so, then overall stockholder wealth would not be maximized by the Court's rule. This is particularly important to consider in this case because the collective actions problems facing public stockholders and the per se ban imposed by the Court's rule make it unlikely that the public stockholders could meaningfully bargain to "sell" their right to be free from complete lock-ups back to the controlling stockholders in those instances where the controlling stockholders value it more highly.[279]

Finally, the Court's choice to invalidate the complete lock-up on "authority" grounds and not to limit itself merely to *Unocal* is also troubling and raises many questions that could significantly increase litigation, the Court's role in negotiated acquisitions, and transactional uncertainty. I noted above that the Court's application of *Unocal* was arguably quite limiting and could be seen as a validation of the vast majority of deal protection measures that fall short of the complete lock-up at issue *Omnicare*.[280] Unfortunately, the Court's decision to use separate "authority" grounds is not so easily limited. As discussed above,[281] the Court's explanation of its "authority" grounds was woefully inadequate. What does it mean that a board cannot "disable"[282] itself from exercising its fiduciary duties? And what does it mean to have "unremitting"[283] fiduciary

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[279] This is particularly true since the easiest route for such a transaction to take place – a dual-class structure present at the initial public offering – did not appear to effectuate such a transfer in *Omnicare*. In theory at least, one might draft an IPO certificate of incorporation to include a specific provision allowing the controlling stockholders to completely lock-up the deal. This would, of course, raise the question of whether the board's duties under *Omnicare* could be limited or waived in such a manner.
[280] *See supra* notes 206 through 210 and accompanying text.
[281] *See supra* notes 252 through 264 and accompanying text.
[282] Omnicare, 818 A.2d at 938.
[283] *Id.*

duties? It is impossible to know without getting a better idea of what the fiduciary duties are that are being described by these terms. And here the Court gave virtually no guidance, other than to hold that a fiduciary-out was required. Similarly, the Court did not explain why it thought it necessary to invalidate the complete lock-up on authority grounds in addition to *Unocal*. I have offered one explanation above: that the Court used "authority" grounds simply to clarify that there was no chance a complete lock-up would be upheld in a future transaction.[284] But the Court has yet to give its explanation, and the fact that it included separate "authority" grounds give rise to future uncertainty. One important question, for example, is this: Could a deal protection measure pass muster under *Unocal* only to be invalidated on authority grounds because it "disabled" the board or prevented them from being "unremitting" in the exercise of their fiduciary duties? Only time will tell.[285]

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[284] *See supra* notes 206 through 210 and accompanying text. Absent the separate "authority" based holding, there could have been the reasonable hope that under some future set of circumstances a complete lock-up might pass muster under the relatively flexible and context-specific *Unocal* standard.

[285] Professor Bainbridge has also critiqued the Delaware courts' use of "authority" grounds to invalidate dead-hand and no-hand poison pills. Bainbridge, *Precommitment*, *supra* note 275. He notes that such invalidation improperly calls into question a whole host of legitimate and valuable pre-commitment strategies, such as bond covenants, fair price shark repellents, nonredeemable poison pills, and deal protection measures. *Id*. His concern was based on the decisions in Mentor Graphics Corp. v. Quickturn Design Systems, Inc., 728 A.2d 25, 49 (Del. Ch.), *aff'd on other grounds*, 721 A.2d 1281 (Del. 1998), and Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1991 (Del. Ch. 1998). That concern can only be heightened by the *Omnicare* Court's use of authority grounds to invalidate the complete lock-up. That said, the Court did try to limit the scope of its holding a little, and explained that while merger agreements require a fiduciary out, other "contracts do not . . . because they involve business judgment that are within the *exclusive* province of the board of directors' power to manage the affairs of the corporation." Omnicare, 818 A.2d at 939 n. 88. In other words, *Omnicare* should not cast doubt on the validity of *all* board precommitment strategies and should instead apply only to those that attempt to precommit the shareholders.

Unfortunately, to fully analyze these issues, and weigh all the costs and benefits associated with a comprehensive normative analysis of the Court's opinion, would take me well beyond the scope of this Article's goals. Therefore I simply flag them as important ones to consider in the future.

VI. Some Possible Objections to my Critique and Responses

A. *Introduction*

This Part considers several possible objections to my critique of director primacy and responds to them. I first consider the objection that my critique is based primarily on only one case – *Omnicare*. Next, I consider the possibility that it is unfair to use a case involving a controlling shareholder to critique a model that does not purport to apply to controlling shareholder corporations. Finally, I consider the possibility that director primacy already incorporates an analysis that allows it to account for the allocation of decisionmaking authority to institutions other than the board.

B. *Omnicare is Just One Case*

One might conclude that it is inappropriate or unfair to use one case – *Omincare* – to criticize the director primacy model. Even Professor Bainbridge "freely concede[s]" that Delaware has not explicitly embraced the director primacy model.[286] However, *Omnicare* is not an isolated case. The Delaware courts have become increasingly active in the negotiated acquisition area. Among other things, the Delaware Supreme Court has recently re-affirmed the vitality of the *Blasius* enhanced scrutiny standard as a

[286] Bainbridge, *Takeovers*, *supra* note 8, at 814.

mechanism for protecting the shareholder vote.[287] Previously, Bainbridge had cited a watering down of the *Blasius* test as support for his rejection of the shareholder primacy model.[288] In addition, the Delaware Court of Chancery has taken a close and critical looks at deal protection measures in a number of recent cases.[289] Moreover, the criticisms I make of director primacy are not wholly-rooted in the *Omincare* case alone. That is, most of them would stand even if *Omincare* had never been decided. My fundamental point, for example, is that director primacy overstates the role of the board and that corporate rules at times function to allocate decisionmaking authority to institutions other than the board. *Omnicare* is a focus because it is a recent important case in which the Court rather explicitly adopts an approach consistent with thesis. *Omnicare* is an illustration of my claim, not the sole basis for it. I discuss more non-*Omnicare* support for my contentions in Subpart C below.

C. *Director Primacy Does Purport to Apply to Controlling Shareholder Corporations*

Professor Bainbridge specifically acknowledges that his director primacy model does not apply to corporations with a controlling shareholder.[290] NCS Healthcare had a controlling shareholder group (Outcalt and Shaw). At first glance, it may therefore seem inappropriate to use *Omnicare* as a jumping-off point to criticize director primacy. This

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[287] MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003) (invalidating board attempt to expand its own size and fill the new slots with friendly directors).
[288] Bainbridge, *Takeovers*, *supra* note 8, at 814 n.30.
[289] Phelps Dodge Corp. v. Cyprus Amax Minerals Co., No. CIV.A.17398, 1999 WL 1054255 (Del. Ch. Sept. 27, 1999); ACE Ltd. v. Capital Re. Corp., 747 A.2d 95 (Del. Ch. 1999); *In re* IXC Communications, Inc. S'holders Litig., No. C.A. 17324, 1999 WL 1009174 (Del. Ch. Oct. 27, 1999).
[290] Bainbridge, *Means and Ends, supra* note 8, at 597 (stating that director primacy "requires the absence of a controlling shareholder. . ."); Bainbridge, *Nexus of Contracts*, *supra* note 8, at 34 (noting that "director primacy does not work well with respect to wholly-owned subsidiaries or publicly held corporations with controlling shareholders.")

is not, however, the case. Director primacy is concerned with the "large public corporation characterized by a separation of ownership and control."[291] In a protoypical controlling shareholder corporation, the controlling shareholder will own a control block of stock (often, though not always, a majority) and an equity interest concomitant with that. In other words, ownership and control are unified in the controlling shareholder. This is contrast to the prototypical public corporation, in which ownership is dispersed among many small shareholders that, because of collective action problems, cannot exercise direct control over the corporation. Instead, the board exercises control. Hence, there is a separation of ownership and control.

NCS was a hybrid. It had a controlling shareholder group, but that controlling shareholder group exercised control via a class of stock with multiple votes each. Their voting power was quite disproportionate to their equity ownership. Specifically, the controlling shareholder group owned 20% of the equity but controlled 66% of the votes. In other words, there was separation of ownership and control, which is the trigger for director primacy's application – although that separation was admittedly not complete.[292]

This is not to say that the presence of a controlling stockholder was irrelevant to *Omnicare*. Quite the opposite. Outcalt and Shaw undoubtedly exercised disproportionate *de facto* and *de jure* control over the corporation and (probably) over the board. As I argued above, the consequence of this is that a reviewing court will need to consider that the board may be more likely act to favor the controlling shareholders than the public

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[291] Bainbridge, *Nexus of Contracts*, *supra* note 8, at 14.
[292] *Cf.* Bainbridge, *Nexus of Contracts*, *supra* note 8, at 34 (explaining that director primacy does not work well with controlling shareholder corporations because "ownership of the equity claim and de facto control tend to be united.")

stockholders. To the extent this increases the risk of board decisions contrary the goal of shareholder wealth maximization, it would weigh in favor of assigning decisionmaking authority elsewhere. As argued above in Parts IV.F and V.B, this is one reason why the Court forced the controlling shareholders to refrain from committing themselves to a particular merger prior to the shareholder vote on it. As I discuss below, I think that director primacy's failure to apply to controlling shareholder corporations is both unfortunate and unnecessary. But that aside, my analysis in Parts IV.F and V.B. are not a criticism of director primacy for failing to accommodate the possibility that board decisionmaking should be distrusted in certain situations involving controlling shareholders.[293] Instead, it is support for my more fundamental argument that director primacy is wrong when it concludes that legal rules do not and should not divest the board of decisionmaking authority and vest it elsewhere, such as the shareholders.

In addition, many of the specific criticisms offered in this Article are not dependent on *Omnicare* and I have offered specific non-*Omnicare* examples to support my arguments. For example, I have argued that the business judgment rule, the statutory merger process, and *Unocal* all demonstrate that the function of legal rules is to allocate decisionmaking authority. It is also worth noting that the Court itself did not limit its holding to controlling shareholder-corporations. *Unocal* now applies to deal protection measures regardless. Moreover, the Court was unusually careful not to use *Omnicare* to impose additional duties on controlling shareholders. Indeed, a fair reading of the case is

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[293] It should be noted, moreover, that in some situations board decision making might be more trusted if there is a controlling shareholder because the controlling shareholder has the incentives to monitor the board to ensure its adherence to the shareholder wealth maximization norm. This is something the dispersed public shareholders will have a difficult time doing.

that controlling shareholders *qua* controlling shareholders escape with no additional duties. Instead, the Court focused on the board. Granted, part of the Court's focus was on the board's responsibility to public shareholders when there is a controlling shareholder. But, much of the Court's concern was also focused on the board action which usurped the shareholders role in the statutory merger process. This comes out most particularly in the Court's justification for expanding *Unocal* to deal protection measures. *Omnicare* is a cautionary tale for all boards.

Finally, the fact that director primacy does not purport to apply to controlling shareholders is itself a drawback of the model. This is particularly so since a "significant minority of public corporations *in the U.S.*" have control shareholders.[294] A more multi-institutional approach would include both corporations with and without a controlling shareholder, and the presence of one would be one factor in deciding "who decides." In *Omnicare*, part of the decision allowed the controlling shareholder to have the final say on the merger[295], but required that that final say not be made until the shareholder vote. As I argued above, this is consistent with maximizing shareholder wealth. Moreover, even in a corporation with a controlling shareholder, the significant benefits of board authority that Bainbridge identifies[296] would still exist vis-à-vis the dispersed public shareholders, although the board would likely be dominated by the controlling shareholder. If anything, the presence of controlling shareholder might lead to greater

[294] *See* Coates, *supra* note 183, at 841.
[295] There is nothing in the decision to suggest that Outcalt and Shaw were anything but free to vote their interests as they saw fit at the shareholder meeting. Of course, at the meeting, the conflict in interest between them and the public stockholders with respect to deal protection measures largely disappears.
[296] *See supra* notes 31 through 45 and accompanying text.

deference for certain types of board actions because presumably the controlling shareholder will be able to closely monitor, if not outright control, board decisionmaking to ensure that it benefits the equity owners.[297] Of course, judicial intervention would still be required to the extent that the controlling shareholder acted in such a way as to inappropriately transfer firm wealth to itself at the expense of the public.[298] In sum, although *Omnicare* is not the perfect tool to use to critique director primacy, it is still a useful and important tool. It is also not the only one used in this Article.

D. *Director Primacy is Multi-Institutional*

One might object that I have overstated the strength of director primacy's claims about the board's decisionmaking power. After all, Professor Bainbridge acknowledges that the board's authority is not unfettered and that at times it must be subject to "accountability" mechanisms such as the shareholder vote, the market for corporate control, and judicial review.[299] He also contends that balancing authority and accountability is the central problem of corporate law[300] and suggests that at times the value of accountability may trump the value of authority.[301] Perhaps then, my criticism is nothing more than a quibble over terminology. One professor's "authority/accountability balance" may be another professor's "allocation of decisionmaking authority."

But I don't think so. Two reasons support this. First, director primacy and the sort of analysis I propose in this Article are based on fundamentally different conceptual

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[297] *See supra* note 272 and accompanying text.
[298] For articles on this s*ee, e.g.*, Gilson & Gordon, *supra* note 201; Siegel, *supra* note 217.
[299] *See supra* notes 46 through 49 and accompanying text.
[300] Bainbridge, *Takeovers*, *supra* note 8, at 807.
[301] Bainbridge, *Means and Ends*, *supra* note 8, at 573.

premises. This important conceptual difference causes director primacy to be too "single institutional" in that it does not adequately consider the possibility of decisionmakers other than the board. Second, Professor Bainbridge's analyses contain a number of statements all of which suggest that he does not think the authority/accountability balance is particularly multi-institutional. Each of these reasons is discussed below.

1. DIFFERENT FUNDAMENTAL PREMISES

Professor Bainbridge's director primacy model is based on a fundamentally different conception of corporate law than the one I propose here. Director primacy starts by conceptualizing the corporation as an authority-based organization with the board exercising the "essentially nonreviewable" power of fiat. It then proceeds to examine the circumstances under which the board's power might, under certain circumstances, be subject to "policing" by the courts or other "accountability mechanisms." One important instance Bainbridge cites is the need for "stricter than normal policing" when the board acts with bad motive.[302] Other examples will presumably occur whenever the value of "accountability" outweighs the value of "authority." Each of these values focuses primarily on the board. "Authority" is the value associated with vesting the power of decisionmaking fiat with the board. "Accountability" is associated with the board's adherence to the shareholder wealth maximization norm. Again, the focus is at all times on the board and the costs and benefits of assigning decisionmaking power to it.

My foundational premise is different. It starts with a conception of corporate law as a way of allocating decisionmaking authority to various institutions, including the

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[302] For a discussion of this *see supra* note 243.

board, the shareholders, and the courts. Given this as the starting point, the next question must necessarily be how to choose the appropriate decisionmaker. This will turn on which institution is best suited to advance the ultimate goal of corporate law. This requires an analysis of the costs and benefits of assigning decisionmaking authority to various institutions, not just the board. It will then require a comparison be made between the institutions to determine which is the best in a given circumstance or set of circumstances. In sum, I advocate for a multi-institutional approach whereas director primacy is more single institutional in its focus on the board.[303]

Professor Bainbridge might reasonably respond to this conceptual critique that he has considered at least one other institution, namely, the shareholders and has concluded that shareholders in a public corporation should not be a decisionmaker because of their differing interests and information (collectively, the "Information Problem").[304] As discussed,[305] this Information Problem makes shareholders a poor fit for a consensus-based model and quite appropriate for an authority-based model. And in an authority based model it would be inappropriate to delegate authority to them. Put differently, director primacy might be seen in two-stages. The first stage considers whether the corporation ought to be based on a consensus or authority model. In this stage, the possibility of shareholder decisionmaking is considered and rejected, and an authority-based model based on board decisionmaking is instead adopted. In the second stage –

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[303] I should note again that director primacy is only in its first stages of development, and in particular the precise nature of the authority/accountability balance has yet to be fully explored. It is possible that, depending on how that balance is defined, it may become more multi-institutional and consider non-board decisionmakers in a more comprehensive and comparative way.
[304] *See supra* note 43 and accompanying text.
[305] *See id.*

after determining the appropriateness board decisionmaking – authority and accountability are balanced to limit the board. Under this interpretation, shareholders are considered (and rejected) in the director primacy model, but only in the first stage.

But this explanation is inadequate for two reasons. First, it is inadequate because it does not allow for the possibility that under some circumstances the shareholders' Information Problem might be overcome. Second, regardless of what one thinks of the Information Problem, the statutory merger scheme (contrary to director primacy's interpretation) gives shareholders powerful negative control.[306] Director primacy's stage one blanket prohibition does not account for either of these and is thus overreaching.

There is a second problem with the "two stage" response to my critique of director primacy. The stage one inquiry by which shareholder decisionmaking was rejected was too narrow. It focused on the Information Problem but did not consider other relevant factors. Among other things, it did not adequately consider the possibility that the board may be a worse decisionmaker than the shareholders because of a conflict of interest, even after accounting for the Information Problem. To be sure, director primacy considers board conflicts of interest, but only in stage two – after it has rejected shareholder decisionmaking. Again, getting back to the function of legal rules. If the function of legal rules is to allocate decisionmaking authority, then all the relevant factors should be considered before making that decision. Director primacy bifurcates the analysis and considers only the Information Problem in stage one, and then considers the conflict of interest problem only in stage two.

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[306]*See supra* notes 172 through 187 and accompanying text.

The board's advantages and disadvantages and the shareholders advantages and disadvantages, however, should be considered together. This is necessary to make a comparative judgment about which institution will be the best decisionmaker. It may be that in a given instance or class of instances the board suffers from a significant disability (like a conflict of interest) but in those same instance(s) the shareholders' Information Problem and other collective action problems are mitigated. For example, as argued above in Part IV.F[307], by forcing controlling shareholders to abstain from deciding on a merger until the shareholder vote, *Omnicare* in effect harmonizes the interests of controlling shareholders and public shareholders that would otherwise diverge on risk aversion grounds. At least part of the Information Problem is therefore mitigated. Similarly, in a merger and acquisition setting the nature of the question to be decided by the decisionmaker is relatively straightforward and capable of resolution by the shareholders. This may be particularly so in statutory mergers where the board has already decided to sell the company and a subsequent bid merges.[308] Here, the primary question may often be the relatively simple one of price and the process is in place to provide shareholders with information and the opportunity to vote (either by ballot or by tendering/not tendering their shares). Put differently, transaction costs are likely to be lower. In addition, by the time of the shareholder meeting many of the company's shares

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[307] *See supra* notes 213 through 239 and accompanying text.
[308] Note that the "just say no" defense or hostile takeover defenses generally may involve more complex analyses of whether the buyer is trying to buy the company on the cheap and so forth. These could, arguably, be relatively more difficult for the shareholders to decide given their limited information and incentives to seek out or process more information.

will be owned by sophisticated arbitrageurs owning relatively large amounts of stock.[309] This should mitigate the collective actions problems that otherwise face shareholders. All this is not to say that shareholder decisionmaking would be perfect or cost-free under these circumstances. At this point, I do not even claim that it would necessarily be appropriate. I argue only that the possibility of shareholder decisionmaking needs to be carefully considered and compared in a comprehensive way with board (and court) decisionmaking.[310] Director primacy does not currently do that. Its bifurcated analysis is not sufficiently comparative and its accountability/authority balance paradigm is too focused on the board to the exclusion of other institutions.

In addition, the accountability/authority paradigm does not seem to provide a method for evaluating the court as a decisionmaking institution. To be sure, director primacy sees a role for the court as a police officer disciplining the board. But the conditions under which this policing are to occur seem primarily concerned with whether the board needs policing to ensure it is acting to further shareholder wealth maximization. This is, however, an insufficient condition for judicial intervention. Even if the board is doing a bad or even a bad faith job, assigning the task of deciding to the courts may result in an even worse outcome. The extent to which the board is doing a bad job needs to be

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[309] *See* Hu, *New Financial Products*, *supra* note 224, at 1305 (noting that in connection with mergers and acquisitions "shareholders often sell to "risk arbitrageurs," professionals who attempt to profit by speculating on mergers, acquisitions, and other corporate restructurings.") The fact that "the shareholders" by the time of the shareholder meeting may consist primary of such arbitrageurs may well raise other interest questions. For example, will they act in a manner consistent maximizing overall stockholder or social wealth, or are their incentives such that they will make suboptimal decisions?

[310] For an argument in favor of increased shareholder involvement *see* Thompson and Smith, *supra* note 13; Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and the Limits on the Board's Power to "Just Say No,"* 67 U. CIN. L. REV. 999 (1999).

weighed against the extent to which the courts might do a better job. As currently configured, this analysis does not seem to be part of the authority/accountability paradigm. In sum, there are important differences between the board-focused way in which director primacy conceptualizes the role of corporate law and the more multi-institutional way in which this Article conceptualizes that role.

2. PROFESSOR BAINBRIDGE'S EXPLANATION OF DIRECTOR PRIMACY IS NOT MULTI-INSTITUTIONAL

Even if the authority/accountability paradigm could be stretched to be more multi-institutional, I do not think that is Professor Bainbridge's intent. His discussion of this balancing makes it quite clear that his focus is the board, and only the board, and that he does not consider shareholders (for one) to be a viable decisionmaking institution. This is reflected in his strongly stated preference for the value of authority (or "fiat") in any balancing that might occur. For example, he notes that "[t]he substantial virtues of fiat can be realized only by preserving the board's decisionmaking authority from being trumped by either shareholders or courts."[311] And: "Ultimately, fiat is both the defining characteristic of corporate governance and its overarching value." When authority/fiat trumps accountability then the board should be the decisionmaker. Accordingly, given that authority/fiat is the "overarching value," it naturally follows that for Professor Bainbridge concludes that "[s]hareholder primacy is inconsistent with the efficient exercise of fiat. . . Indeed, if shareholders could routinely review board decisions, the directors' power of fiat would become merely advisory rather than authoritative. Shareholder primacy thus is inconsistent with the separation of ownership and control,

[311] Bainbridge, *Means and Ends*, *supra* note 8, at 605.

which ensures that the board's power of fiat remains authoritative."[312] Director primacy, by its own terms, is not very multi-institutional.

Even the theoretical possibility of shareholder decisionmaking under director primacy is viewed through the lens of board decisionmaking. Professor Bainbridge explains that shareholder decisionmaking "could be justified under the director primacy model only if such choice were a desirable way of ensuring director accountability for shareholder wealth maximization."[313] In other words, even if shareholder decisionmaking were acceptable under director primacy (and it is not), it would be acceptable only if it were a way of ensuring that the board properly exercise its decisionmaking authority. This is quite different from a multi-institutional approach under which the shareholders would be treated as a separate decisionmaking institution to whom authority might be vested simply because they were a better decisionmaker than alternative institutions.[314] Under my approach, the shareholders might get the decisionmaking job because they were better at it then the board under the circumstances, not because giving it to them might improve board decisionmaking. This is another example of director primacy being too board-focused.

VII. CONCLUSION

Corporate legal rules function to allocate decisionmaking authority among various potential decisionmakers, including the board, shareholders and the courts. This point is fundamental to understanding *Omnicare* and corporate law generally. It is also

[312] Bainbridge, *Means and Ends, supra* note 8, at 572-73.
[313] Bainbridge, *Takeovers*, *supra* note 8, at 805-06.
[314] Once more, I admit that the situations under which this should occur are rare. But they are important nonetheless.

demonstrates a shortcoming in the otherwise promising director primacy model of corporate law. This is not to say *Omnicare* is a perfect decision by any means. It has many shortcomings, some of which are discussed in this Article, and many of which I am sure will be discussed in others. But by focusing on the function of corporate legal rules, one can at least gain a better understanding of what the Court did (and attempted to do) in that case. Any meaningful critique of *Omnicare*, indeed, any meaningful analysis of any corporate legal rules, needs to account for corporate law's function, i.e., to allocate decisionmaking authority. Only by first understanding what corporate law does, can one hope to offer a complete evaluation of it.