TAB "8"

▷

Supreme Court of the United States
BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, Petitioner,
v.
203 NORTH LaSALLE STREET PARTNERSHIP.
No. 97-1418.

Argued Nov. 2, 1998.
Decided May 3, 1999.

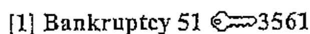
Secured creditor objected to confirmation of debtor-limited partnership's proposed Chapter 11 plan. The Bankruptcy Court, Eugene R. Wedoff, J., 190 B.R. 567, confirmed plan, and creditor appealed. After denying creditor's emergency motion for stay pending appeal, 190 B.R. 595, the United States District Court for the Northern District of Illinois, Paul E. Plunkett, J., 195 B.R. 692, affirmed. Creditor appealed. The Court of Appeals for the Seventh Circuit, 126 F.3d 955, affirmed. Certiorari was granted. The Supreme Court, Justice Souter, held that, assuming absolute priority rule contains new value corollary or exception, debtor's prebankruptcy equity holders could not, over objection of senior class of impaired creditors, contribute new capital and receive ownership interests in reorganized entity without allowing others to compete for that equity or to propose competing reorganization plan.

Reversed and remanded.

Justice Thomas filed an opinion concurring in the judgment, in which Justice Scalia joined.

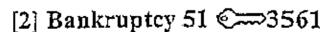
Justice Stevens filed a dissenting opinion.

West Headnotes


[1] Bankruptcy 51 ⟹3561

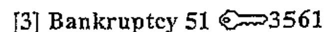
51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3561 k. Preservation of Priority. Most Cited Cases

Supreme Court has not decided whether any new value corollary or exception to absolute priority rule remains viable following codification of absolute priority rule, although legislative history does nothing to disparage the possibility apparent in the statutory text, that the absolute priority rule as currently codified may carry a new value corollary. Bankr.Code, 11 U.S.C.A. § 1129(b)(2)(B)(ii).


[2] Bankruptcy 51 ⟹3561

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3561 k. Preservation of Priority. Most Cited Cases

As used in absolute priority rule, which bars cramdown if junior interest holder receives or retains property under proposed Chapter 11 plan "on account of" such junior interest, the "on account of" modifier cannot be interpreted to mean "in exchange for," or "in satisfaction of," but, rather, should reflect the more common understanding of "on account of" to mean "because of," such that absolute priority rule will be activated by a causal relationship between holding the prior claim or interest and receiving or retaining property. Bankr.Code, 11 U.S.C.A. § 1129(b)(2)(B)(ii).


[3] Bankruptcy 51 ⟹3561

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3561 k. Preservation of Priority. Most Cited Cases

Chapter 11 debtor's prebankruptcy equity holders could not, over objection of senior class of impaired creditors, contribute new capital and receive ownership interests in reorganized entity, when that opportunity was given exclusively to old equity

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holders under reorganization plan adopted without consideration of alternatives; plan violated absolute priority rule by its provision for vesting equity in reorganized business in the debtor's partners, without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan. Bankr.Code, 11 U.S.C.A. § 1129(b)(2)(B)(ii).

[4] **Bankruptcy 51 🔑3561**

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3561 k. Preservation of Priority. Most Cited Cases

Assuming a new value corollary to absolute priority rule, Chapter 11 plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within prohibition of absolute priority rule. Bankr.Code, 11 U.S.C.A. § 1129(b)(2)(B)(ii).

***1412 Syllabus* FN*

FN* The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States v. Detroit Timber & Lumber Co.,* 200 U.S. 321, 337, 26 S.Ct. 282, 50 L.Ed. 499.

A loan by petitioner Bank of America National Trust and Savings Association (Bank) to respondent 203 North LaSalle Street Partnership (Debtor) was secured by a mortgage on the Debtor's interest in a Chicago office building, the value of which was less than the balance due the Bank. After the Debtor defaulted and the Bank began state-court foreclosure, the Debtor filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 1101 *et seq.* The Debtor proposed a reorganization plan under which, *inter alia,* certain of its former partners would contribute new capital in exchange for the Debtor's entire ownership of the reorganized entity. That condition was an exclusive eligibility provision: the old equity holders were the only ones who could contribute new capital. The Bank objected and, as sole member of an impaired class of creditors, thereby blocked confirmation of the plan on a consensual basis. See § 1129(a)(8). The Debtor, however, resorted to the alternate, judicial "cramdown" process for imposing a plan on a dissenting class. § 1129(b). Among the conditions for a cramdown is the requirement that the plan be "fair and equitable" with respect to each class of impaired unsecured claims that has not accepted it. § 1129(b)(1). A plan may be found to be fair and equitable if "the holder of any claim ... junior to the claims of such class will not receive or retain under the plan on account of such junior claim ... any property." § 1129(b)(2)(B)(ii). Under this "absolute priority rule," the Bank argued, the plan could not be confirmed as a cramdown because the Debtor's old equity holders would receive property even though the Bank's unsecured deficiency claim would not be paid in full. The Bankruptcy Court approved the plan nonetheless, and the District Court and the Court of Appeals affirmed. The Seventh Circuit found ambiguity in the absolute priority rule's language, and interpreted the phrase "on account of " to permit recognition of a "new value corollary" to the rule, under which the objection of an impaired senior class does not bar junior claim holders from receiving or retaining property interests in the debtor after reorganization, if they contribute new capital in money or money's worth, reasonably equivalent to the property's value, and ***435** necessary for successful reorganization of the restructured enterprise. The court held that when an old equity holder retains an equity interest in the reorganized debtor by meeting the corollary's requirements, he is not receiving or retaining that interest "on account of " his prior equitable ownership, but, rather, "on account of " a new, substantial, necessary, and fair infusion of capital.

Held: A debtor's prebankruptcy equity holders may not, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in the reorganized entity, when that

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opportunity is given exclusively to the old equity holders under a plan adopted without consideration of alternatives. The old equity holders**1413 are disqualified from participating in such a "new value" transaction by § 1129(b)(2)(B)(ii), which in these circumstances bars a junior interest holder's receipt of any property on account of his prior interest. Pp. 1417-1424.

(a) The Court does not decide whether the statute includes a new value corollary or exception. The drafting history is equivocal, but does nothing to disparage the possibility apparent in the statutory text, that § 1129(b)(2)(B)(ii) may carry such a corollary. Although there is no literal reference to "new value" in the phrase "on account of such junior claim," the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid. Pp. 1417-1419.

(b) The Court adopts as the better reading of the "on account of " modifier the more common understanding that the phrase means "because of," since this is the usage meant for the phrase at other places in the statute, see *Cohen v. De La Cruz,* 523 U.S. 213, 219-220, 118 S.Ct. 1212, 140 L.Ed.2d 341. Thus, a causal relationship between holding the prior claim or interest and receiving or retaining property is what activates the absolute priority rule. As to the degree of causation that will disqualify a plan, the Government argues not only that any degree of causation between earlier interests and retained property will activate the bar to a plan providing for later property, but also that whenever the holders of equity in the Debtor end up with some property there will be some causation. A less absolute statutory prohibition would follow from reading the "on account of " language as intended to reconcile the two recognized policies underlying Chapter 11, of preserving going concerns and maximizing property available to satisfy creditors, see *Toibb v. Radloff,* 501 U.S. 157, 163, 111 S.Ct. 2197, 115 L.Ed.2d 145. Causation between the old equity's holdings and subsequent property substantial enough to disqualify a plan would presumably occur on this view whenever old equity's later property*936 would come at a price that failed to provide the greatest possible addition to the bankruptcy estate, *i.e.,* whenever the equity holders obtained or preserved an ownership interest for less than someone else would have paid. Pp. 1419-1422.

(c) Assuming a new value corollary, plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within § 1129(b)(2)(B)(ii)'s prohibition. In this case, the proposed plan is doomed by its provision for vesting equity in the reorganized business in the Debtor's partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan. The exclusiveness of the opportunity, with its protection against the market's scrutiny of the stated purchase price, renders the partners' right a property interest extended "on account of " the old equity position and therefore subject to an unpaid senior creditor class's objection. Under a plan granting old equity on exclusive right, any determination that the purchase price was top dollar would necessarily be made by the bankruptcy judge, whereas the best way to determine value is exposure to a market. In the interest of statutory coherence, the Bankruptcy Code's disfavor for decisions untested by competitive choice ought to extend to valuations in administering § 1129(b)(2)(B)(ii) when some form of market valuation may be available to test the adequacy of an old equity holder's proposed contribution. Pp. 1422-1424.

126 F.3d 955, reversed and remanded.

SOUTER, J., delivered the opinion of the Court, in which REHNQUIST, C.J., and O'CONNOR, KENNEDY, GINSBURG, and BREYER, JJ., joined. THOMAS, J., filed an opinion concurring in the judgment, in which SCALIA, J., joined, *post,* p. 1424. STEVENS, J., filed a dissenting opinion, *post* , p. 1426.

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Roy T. Englert, Jr., Washington, DC, for petitioner.

Patricia A. Millett, Washington, DC, for United States as amicus curiae, by special leave of the Court.

**1414*437 Richard M. Bendix, Jr., Chicago, IL, for respondent.

For U.S. Supreme Court briefs, see:1998 WL 265043 (Pet.Brief)1998 WL 346624 (Pet.Brief)1998 WL 536354 (Resp.Brief)1998 WL 732924 (Pet.Supp.Brief)1998 WL 727547 (Resp.Supp.Brief)

Justice SOUTER delivered the opinion of the Court.

The issue in this Chapter 11 reorganization case is whether a debtor's prebankruptcy equity holders may, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in the reorganized entity, when that opportunity is given exclusively to the old equity holders under a plan adopted without consideration of alternatives. We hold that old equity holders are disqualified from participating in such a "new value" transaction by the terms of 11 U.S.C. § 1129(b)(2)(B)(ii), which in such circumstances bars a junior interest holder's receipt of any property on account of his prior interest.

I

Petitioner, Bank of America National Trust and Savings Association (Bank), [FN1] is the major creditor of respondent, 203 North LaSalle Street Partnership (Debtor or Partnership), *438 an Illinois real estate limited partnership. [FN2] The Bank lent the Debtor some $93 million, secured by a nonrecourse first mortgage [FN3] on the Debtor's principal asset, 15 floors of an office building in downtown Chicago. In January 1995, the Debtor defaulted, and the Bank began foreclosure in a state court.

FN1. Bank of America, Illinois, was the appellant in the case below. As a result of a merger, it is now known as Bank of America National Trust and Savings Association.

FN2. The limited partners in this case are considered the Debtor's equity holders under the Bankruptcy Code, see 11 U.S.C. §§ 101(16), (17), and the Debtor Partnership's actions may be understood as taken on behalf of its equity holders.

FN3. A nonrecourse loan requires the Bank to look only to the Debtor's collateral for payment. But see n. 6, *infra*.

In March, the Debtor responded with a voluntary petition for relief under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 1101 *et seq.*, which automatically stayed the foreclosure proceedings, see § 362(a). *In re 203 N. LaSalle Street Partnership*, 126 F.3d 955, 958 (C.A.7 1997); *Bank of America, Illinois v. 203 N. LaSalle Street Partnership*, 195 B.R. 692, 696 (N.D.Ill.1996). The Debtor's principal objective was to ensure that its partners retained title to the property so as to avoid roughly $20 million in personal tax liabilities, which would fall due if the Bank foreclosed. 126 F.3d, at 958, 195 B.R., at 698. The Debtor proceeded to propose a reorganization plan during the 120-day period when it alone had the right to do so, see 11 U.S.C. § 1121(b); see also § 1121(c) (exclusivity period extends to 180 days if the debtor files plan within the initial 120 days). [FN4] The Bankruptcy Court rejected the Bank's motion to terminate the period of exclusivity to make way for a plan of its own to *439 liquidate the property, and instead extended the exclusivity period for cause shown, under § 1121(d). [FN5]

FN4. The Debtor filed an initial plan on April 13, 1995, and amended it on May 12, 1995. The Bank objected, and the Bankruptcy Court rejected the plan on the ground that it was not feasible. See § 1129(a)(11). The Debtor submitted a new

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plan on September 11, 1995. *In re 203 N. LaSalle,* 126 F.3d 955, 958-959 (C.A.7 1997).

FN5. The Bank neither appealed the denial nor raised it as an issue in this appeal.

The value of the mortgaged property was less than the balance due the Bank, which elected to divide its undersecured claim into secured and unsecured deficiency claims under § 506(a) and § 1111(b). FN6 126 F.3d, at 958. Under the plan, the Debtor separately classified the Bank's secured claim, its unsecured deficiency claim, and unsecured trade **1415 debt owed to other creditors. See § 1122(a). FN7 The Bankruptcy Court found that the Debtor's available assets were prepetition rents in a cash account of $3.1 million and the 15 floors of rental property worth $54.5 million. The secured claim was valued at the latter figure, leaving the Bank with an unsecured deficiency of $38.5 million.

FN6. Having agreed to waive recourse against any property of the Debtor other than the real estate, the Bank had no unsecured claim outside of Chapter 11. Section 1111(b), however, provides that nonrecourse secured creditors who are undersecured must be treated in Chapter 11 as if they had recourse.

FN7. Indeed, the Seventh Circuit apparently requires separate classification of the deficiency claim of an undersecured creditor from other general unsecured claims. See *In re Woodbrook Associates,* 19 F.3d 312, 319 (1994). Nonetheless, the Bank argued that if its deficiency claim had been included in the class of general unsecured creditors, its vote against confirmation would have resulted in the plan's rejection by that class. The Bankruptcy Court and the District Court rejected the contention that the classifications were gerrymandered to obtain requisite approval by a single class, *In re 203 N. LaSalle Street Limited Partnership,* 190 B.R. 567, 592-593 (Bkrtcy.N.D.Ill.1995); *Bank of America, Illinois v. 203 N. LaSalle Street Partnership,* 195 B.R. 692, 705 (N.D.Ill.1996), and the Court of Appeals agreed, 126 F.3d, at 968. The Bank sought no review of that issue, which is thus not before us.

So far as we need be concerned here, the Debtor's plan had these further features:

*440 (1) The Bank's $54.5 million secured claim would be paid in full between 7 and 10 years after the original 1995 repayment date. FN8

FN8. Payment consisted of a prompt cash payment of $1,149,500 and a secured, 7-year note, extendable at the Debtor's option. 126 F.3d, at 959, n. 4, 195 B.R., at 698.

(2) The Bank's $38.5 million unsecured deficiency claim would be discharged for an estimated 16% of its present value. FN9

FN9. This expected yield was based upon the Bankruptcy Court's projection that a sale or refinancing of the property on the 10th anniversary of the plan confirmation would produce a $19-million distribution to the Bank.

(3) The remaining unsecured claims of $90,000, held by the outside trade creditors, would be paid in full, without interest, on the effective date of the plan. FN10

FN10. The Debtor originally owed $160,000 in unsecured trade debt. After filing for bankruptcy, the general partners purchased some of the trade claims. Upon confirmation, the insiders would waive all general unsecured claims they held. 126 F.3d, at 958, n. 2, 195 B.R., at 698.

(4) Certain former partners of the Debtor would

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contribute $6.125 million in new capital over the course of five years (the contribution being worth some $4.1 million in present value), in exchange for the Partnership's entire ownership of the reorganized debtor.

The last condition was an exclusive eligibility provision: the old equity holders were the only ones who could contribute new capital.[FN11]

FN11. The plan eliminated the interests of noncontributing partners. More than 60% of the Partnership interests would change hands on confirmation of the plan. See Brief for Respondent 4, n. 7. The new Partnership, however, would consist solely of former partners, a feature critical to the preservation of the Partnership's tax shelter. Tr. of Oral Arg. 32.

The Bank objected and, being the sole member of an impaired class of creditors, thereby blocked confirmation of the *441 plan on a consensual basis. See § 1129(a)(8).[FN12] The Debtor, however, took the alternate route to confirmation of a reorganization plan, forthrightly known as the judicial "cramdown" process for imposing a plan on a dissenting class. § 1129(b). See generally Klee, All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 Am. Bankr.L.J. 133 (1979).

FN12. A class of creditors accepts if a majority of the creditors and those holding two-thirds of the total dollar amount of the claims within that class vote to approve the plan. § 1126(c).

There are two conditions for a cramdown. First, all requirements of § 1129(a) must be met (save for the plan's acceptance by each impaired class of claims or interests, see § 1129(a)(8)). Critical among them are the conditions that the plan be accepted by at least one class of impaired creditors, see § 1129(a)(10), and satisfy the "best-interest-of-creditors" test, see § 1129(a)(7).[FN13] Here, **1416 the class of trade creditors with impaired unsecured claims voted for the plan,[FN14] 126 F.3d, at 959, and there was no issue of best interest. Second, the objection of an impaired creditor class may be overridden only if "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." § 1129(b)(1). As to a dissenting class of impaired unsecured creditors, such a plan may be found to be "fair and equitable" only if the allowed value of the claim is to be paid in full, § 1129(b)(2)(B)(i), or, in the alternative, *442 if "the holder of any claim or interest that is junior to the claims of such [impaired unsecured] class will not receive or retain under the plan on account of such junior claim or interest any property," § 1129(b)(2)(B)(ii). That latter condition is the core of what is known as the "absolute priority rule."

FN13. Section 1129(a)(7) provides that if the holder of a claim impaired under a plan of reorganization has not accepted the plan, then such holder must "receive ... on account of such claim ... property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive ... if the debtor were liquidated under chapter 7 ... on such date." The "best interests" test applies to individual creditors holding impaired claims, even if the class as a whole votes to accept the plan.

FN14. Claims are unimpaired if they retain all of their prepetition legal, equitable, and contractual rights against the debtor. § 1124.

The absolute priority rule was the basis for the Bank's position that the plan could not be confirmed as a cramdown. As the Bank read the rule, the plan was open to objection simply because certain old equity holders in the Debtor Partnership would receive property even though the Bank's unsecured deficiency claim would not be paid in full. The Bankruptcy Court approved the plan nonethe-

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less, and accordingly denied the Bank's pending motion to convert the case to Chapter 7 liquidation, or to dismiss the case. The District Court affirmed, 195 B.R. 692 (N.D.Ill.1996), as did the Court of Appeals.

The majority of the Seventh Circuit's divided panel found ambiguity in the language of the statutory absolute priority rule, and looked beyond the text to interpret the phrase "on account of " as permitting recognition of a "new value corollary" to the rule. 126 F.3d, at 964-965. According to the panel, the corollary, as stated by this Court in *Case v. Los Angeles Lumber Products Co.,* 308 U.S. 106, 118, 60 S.Ct. 1, 84 L.Ed. 110 (1939), provides that the objection of an impaired senior class does not bar junior claim holders from receiving or retaining property interests in the debtor after reorganization, if they contribute new capital in money or money's worth, reasonably equivalent to the property's value, and necessary for successful reorganization of the restructured enterprise. The panel majority held that

> "when an old equity holder retains an equity interest in the reorganized debtor by meeting the requirements of the new value corollary, he is not receiving or retaining that interest 'on account of ' his prior equitable ownership*443 of the debtor. Rather, he is allowed to participate in the reorganized entity 'on account of ' a new, substantial, necessary and fair infusion of capital." 126 F.3d, at 964.

In the dissent's contrary view, there is nothing ambiguous about the text: the "plain language of the absolute priority rule ... does not include a new value exception." *Id.,* at 970 (opinion of Kanne, J.). Since "[t]he Plan in this case gives [the Debtor's] partners the exclusive right to retain their ownership interest in the indebted property *because of* their status as ... prior interest holder[s]," *id.,* at 973, the dissent would have reversed confirmation of the plan.

We granted certiorari, 523 U.S. 1106, 118 S.Ct. 1674, 140 L.Ed.2d 812 (1998), to resolve a Circuit split on the issue. The Seventh Circuit in this case joined the Ninth in relying on a new value corollary to the absolute priority rule to support confirmation of such plans. See *In re Bonner Mall Partnership,* 2 F.3d 899, 910-916 (C.A.9 1993), cert. granted, 510 U.S. 1039, 114 S.Ct. 681, 126 L.Ed.2d 648, vacatur denied and appeal dism'd as moot, 513 U.S. 18, 115 S.Ct. 386, 130 L.Ed.2d 233 (1994). The Second and Fourth Circuits, by contrast, without explicitly rejecting the corollary, have disapproved plans similar to this one. See *In re Coltex Loop Central Three Partners, L. P.,* 138 F.3d 39, 44-45 (C.A.2 1998); *In re Bryson Properties, XVIII,* 961 F.2d 496, 504 (C.A.4 1992), cert. denied, **1417506 U.S. 866, 113 S.Ct. 191, 121 L.Ed.2d 134 (1992).[FN15] We do not decide whether the statute includes a new value corollary or exception, but hold that on any reading respondent's proposed plan fails to satisfy the statute, and accordingly reverse.

> FN15. All four of these cases arose in the single-asset real estate context, the typical one in which new value plans are proposed. See 7 Collier on Bankruptcy ¶ 1129.04[4][c][ii][B], p. 1129-113 (rev. 15th ed.1998). See also Strub, Competition, Bargaining, and Exclusivity under the New Value Rule: Applying the Single-Asset Paradigm of *Bonner Mall,* 111 Banking L.J. 228, 231 (1994) ("Most of the cases discussing the new value issue have done so in connection with an attempt by a single-asset debtor to reorganize under chapter 11").

*444 II

The terms "absolute priority rule" and "new value corollary" (or "exception") are creatures of law antedating the current Bankruptcy Code, and to understand both those terms and the related but inexact language of the Code some history is helpful. The Bankruptcy Act preceding the Code contained no such provision as subsection (b)(2)(B)(ii), its

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subject having been addressed by two interpretive rules. The first was a specific gloss on the requirement of § 77B (and its successor, Chapter X) of the old Act, that any reorganization plan be "fair and equitable." 11 U.S.C. § 205(e) (1934 ed., Supp. I) (repealed 1938) (§ 77B); 11 U.S.C. § 621(2) (1934 ed., Supp. IV) (repealed 1979) (Chapter X). The reason for such a limitation was the danger inherent in any reorganization plan proposed by a debtor, then and now, that the plan will simply turn out to be too good a deal for the debtor's owners. See H.R. Doc. No. 93-137, pt. I, p. 255 (1973) (discussing concern with "the ability of a few insiders, whether representatives of management or major creditors, to use the reorganization process to gain an unfair advantage"); *ibid.* ("[I]t was believed that creditors, because of management's position of dominance, were not able to bargain effectively without a clear standard of fairness and judicial control"); Ayer, Rethinking Absolute Priority After *Ahlers,* 87 Mich. L.Rev. 963, 969-973 (1989). Hence the pre-Code judicial response known as the absolute priority rule, that fairness and equity required that "the creditors ... be paid before the stockholders could retain [equity interests] for any purpose whatever." *Northern Pacific R. Co. v. Boyd,* 228 U.S. 482, 508, 33 S.Ct. 554, 57 L.Ed. 931 (1913). See also *Louisville Trust Co. v. Louisville, N.A. & C.R. Co.,* 174 U.S. 674, 684, 19 S.Ct. 827, 43 L.Ed. 1130 (1899) (reciting "the familiar rule that the stockholder's interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors," and concluding that "any arrangement of the parties by which the subordinate*445 rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation").

The second interpretive rule addressed the first. Its classic formulation occurred in *Case v. Los Angeles Lumber Products Co.,* in which the Court spoke through Justice Douglas in this dictum:

> "It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor.... Where th[e] necessity [for new capital] exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made....
>
> "[W]e believe that to accord 'the creditor his full right of priority against the corporate assets' where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." 308 U.S., at 121-122, 60 S.Ct. 1.

Although counsel for one of the parties here has described the *Case* observation as " 'black-letter' principle," Brief for Respondent 38, it never rose above the technical level of dictum in any opinion of this Court, which last addressed it in *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988), holding that a contribution of " 'labor, experience, and expertise' " by a junior interest holder was not in the " 'money's worth' " that the *Case* **1418 observation required. 485 U.S., at 203-205, 108 S.Ct. 963. See also *Marine Harbor Properties, Inc. v. Manufacturers Trust Co.,* 317 U.S. 78, 85, 63 S.Ct. 93, 87 L.Ed. 64 (1942); *Consolidated Rock Products Co. v. Du Bois,* 312 U.S. 510, 529, n. 27, 61 S.Ct. 675, 85 L.Ed. 982 (1941). Nor, prior to the enactment of the current Bankruptcy Code, *446 did any court rely on the *Case* dictum to approve a plan that gave old equity a property right after reorganization. See Ayer, *supra,* at 1016; Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 Stan. L.Rev. 69, 92 (1991). Hence the controversy over how weighty the *Case* dictum had become, as reflected in the alternative labels for the new value notion: some writers and courts (including this one, see *Ahlers, supra,* at 203-204, n. 3, 108 S.Ct. 963) have spoken of it as an exception to the absolute priority rule, see, *e.g., In re*

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Potter Material Service, Inc., 781 F.2d 99, 101 (C.A.7 1986); Miller, Bankruptcy's New Value Exception: No Longer a Necessity, 77 B.U.L.Rev. 975 (1997); Georgakopoulos, New Value, Fresh Start, 3 Stan. J.L. Bus. & Fin. 125 (1997), while others have characterized it as a simple corollary to the rule, see, *e.g., In re Bonner Mall Partnership,* 2 F.3d, at 906; Ayer, *supra,* at 999.

Enactment of the Bankruptcy Code in place of the prior Act might have resolved the status of new value by a provision bearing its name or at least unmistakably couched in its terms, but the Congress chose not to avail itself of that opportunity. In 1973, Congress had considered proposals by the Bankruptcy Commission that included a recommendation to make the absolute priority rule more supple by allowing nonmonetary new value contributions. H.R. Doc. No. 93-137, pt. I, at 258-259; *id.,* pt. II, at 242, 252. Although Congress took no action on any of the ensuing bills containing language that would have enacted such an expanded new value concept,[FN16] each of them was reintroduced in the next congressional session. See H.R. 31, 94th Cong., 1st Sess., *447 §§ 7-303(4),[FN17] 7-310(d)(2)(B) (1975);[FN18] H.R. 32, 94th Cong., 1st Sess., §§ 7-301(4), 7-308(d)(2)(B) (1975); S. 235, 94th Cong., 1st Sess., §§ 7-301(4), 7-308(d)(2)(B) (1975); S. 236, 94th Cong., 1st Sess., §§ 7-303(4), 7-310(d)(2)(B) (1975). After extensive hearings, a substantially revised House bill emerged, but without any provision for nonmonetary new value contributions. See H.R. 6, 95th Cong., 1st Sess., §§ 1123, 1129(b) (1977).[FN19] After a lengthy markup session, the House produced H.R. 8200, 95th Cong., 1st Sess. (1977), which would eventually become the law, H.R.Rep. No. 95-595, p. 3 (1977), U.S.Code Cong. & Admin. News (1978), p. 5964. It had no explicit new value language, expansive or otherwise, but did codify the absolute priority rule in nearly its present form. See H.R. 8200, *supra,* § 1129(b)(2)(B)(iv) ("[T]he holders of claims or interests of any class of claims or interests,**1419 as the case may be, that is junior to such class will not receive or retain under *448 the plan on account of such junior claims or interests any property").[FN20]

FN16. See H.R. 10792, 93d Cong., 1st Sess., §§ 7-303(4), 7-310(d)(2)(B) (1973); H.R. 16643, 93d Cong., 2d Sess., §§ 7-301(4), 7-308(d)(2)(B) (1974); S. 2565, 93d Cong., 1st Sess., §§ 7-303(4), 7-310(d)(2)(B) (1973); S. 4046, 93d Cong., 2d Sess., §§ 7-301(4), 7-308(d)(2)(B) (1974).

FN17. Section 7-303(4) read: "[W]hen the equity security holders retain an interest under the plan, the individual debtor, certain partners or equity security holders will make a contribution which is important to the operation of the reorganized debtor or the successor under the plan, for participation by the individual debtor, such partners, or such holders under the plan on a basis which reasonably approximates the value, if any, of their interests, and the additional estimated value of such contribution."

FN18. Section 7-310(d)(2)(B) read: "Subject to the provisions of section 7-303(3) and (4) and the court's making any findings required thereby, there is a reasonable basis for the valuation on which the plan is based and the plan is fair and equitable in that there is a reasonable probability that the securities issued and other consideration distributed under the plan will fully compensate the respective classes of creditors and equity security holders of the debtor for their respective interests in the debtor or his property."

FN19. Section 1129(b) of H.R. 6 read, in relevant part: "[T]he court, on request of the proponent of such plan, shall confirm such plan ... if such plan is fair and equitable with respect to all classes except any class that has accepted the plan and that is

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comprised of claims or interests on account of which the holders of such claims or interests will receive or retain under the plan not more than would be so received or retained under a plan that is fair and equitable with respect to all classes."

FN20. While the earlier proposed bills contained provisions requiring as a condition of confirmation that a plan be "fair and equitable," none of them contained language explicitly codifying the absolute priority rule. See, *e.g.*, nn. 17-19, *supra*.

For the purpose of plumbing the meaning of subsection (b)(2)(B)(ii) in search of a possible statutory new value exception, the lesson of this drafting history is equivocal. Although hornbook law has it that " 'Congress does not intend *sub silentio* to enact statutory language that it has earlier discarded,' " *INS v. Cardoza-Fonseca,* 480 U.S. 421, 442-443, 107 S.Ct. 1207, 94 L.Ed.2d 434 (1987), the phrase "on account of" is not *silentium,* and the language passed by in this instance had never been in the bill finally enacted, but only in predecessors that died on the vine. None of these contained an explicit codification of the absolute priority rule, FN21 and even in these earlier bills the language in question stated an expansive new value concept, not the rule as limited in the *Case* dictum.FN22

FN21. See n. 20, this page.

FN22. See nn. 17-18, *supra*.

The equivocal note of this drafting history is amplified by another feature of the legislative advance toward the current law. Any argument from drafting history has to account for the fact that the Code does not codify any authoritative pre-Code version of the absolute priority rule. Compare § 1129(b)(2)(B)(ii) ("[T]he holder of any claim or interest that is junior to the claims of such [impaired unsecured] class will not receive or retain under the plan on account of such junior claim or interest any property") with *Boyd,* 228 U.S., at 508, 33 S.Ct. 554 ("[T]he creditors were entitled to be paid before the stockholders could retain [a right of property] for any purpose whatever"), and *Case,* 308 U.S., at 116, 60 S.Ct. 1 (" '[C]reditors are entitled to priority over stockholders against all the property of an insolvent corporation' " (quoting *449*Kansas City Terminal R. Co. v. Central Union Trust Co. of N.Y.,* 271 U.S. 445, 455, 46 S.Ct. 549, 70 L.Ed. 1028 (1926))). See H.R.Rep. No. 95-595, at 414, U.S.Code Cong.& Admin. News 1978, p. 6370. (characterizing § 1129(b)(2)(B)(ii) as a "partial codification of the absolute priority rule"); *ibid.* ("The elements of the [fair and equitable] test are new[,] departing from both the absolute priority rule and the best interests of creditors tests found under the Bankruptcy Act").

[1] The upshot is that this history does nothing to disparage the possibility apparent in the statutory text, that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary. Although there is no literal reference to "new value" in the phrase "on account of such junior claim," the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid.

III

[2] Three basic interpretations have been suggested for the "on account of" modifier. The first reading is proposed by the Partnership, that "on account of " harks back to accounting practice and means something like "in exchange for," or "in satisfaction of," Brief for Respondent 12-13, 15, n. 16. On this view, a plan would not violate the absolute priority rule unless the old equity holders received or retained property in exchange for the prior interest, without any significant new contribution; if substantial money passed from them as part of the deal, the prohibition of subsection (b)(2)(B)(ii) would not stand in the way, and whatever issues of fairness and equity there might otherwise be would not

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implicate the "on account of " modifier.

This position is beset with troubles, the first one being textual. Subsection (b)(2)(B)(ii) forbids not only receipt of property on account of the prior interest but its retention as well. See also §§ 1129(a)(7)(A)(ii), (a)(7)(B), (b)(2)(B)(i); ****1420** (b)(2)(C)(i), (b)(2)(C)(ii). A common instance of the latter ***450** would be a debtor's retention of an interest in the insolvent business reorganized under the plan. Yet it would be exceedingly odd to speak of "retain[ing]" property in exchange for the same property interest, and the eccentricity of such a reading is underscored by the fact that elsewhere in the Code the drafters chose to use the very phrase "in exchange for," § 1123(a)(5)(J) (a plan shall provide adequate means for implementation, including "issuance of securities of the debtor ... for cash, for property, for existing securities, or in exchange for claims or interests"). It is unlikely that the drafters of legislation so long and minutely contemplated as the 1978 Bankruptcy Code would have used two distinctly different forms of words for the same purpose. See *Russello v. United States,* 464 U.S. 16, 23, 104 S.Ct. 296, 78 L.Ed.2d 17 (1983).

The second difficulty is practical: the unlikelihood that Congress meant to impose a condition as manipulable as subsection (b)(2)(B)(ii) would be if "on account of " meant to prohibit merely an exchange unaccompanied by a substantial infusion of new funds but permit one whenever substantial funds changed hands. "Substantial" or "significant" or "considerable" or like characterizations of a monetary contribution would measure it by the Lord Chancellor's foot, and an absolute priority rule so variable would not be much of an absolute. Of course it is true (as already noted) that, even if old equity holders could displace the rule by adding some significant amount of cash to the deal, it would not follow that their plan would be entitled to adoption; a contested plan would still need to satisfy the overriding condition of fairness and equity. But that general fairness and equity criterion would apply in any event, and one comes back to the question why Congress would have bothered to add a separate priority rule without a sharper edge.

Since the "in exchange for " reading merits rejection, the way is open to recognize the more common understanding of "on account of " to mean "because of." This is certainly the usage meant for the phrase at other places in the statute,***451** see § 1111(b)(1)(A) (treating certain claims as if the holder of the claim "had recourse against the debtor on account of such claim"); § 522(d)(10)(E) (permitting debtors to exempt payments under certain benefit plans and contracts "on account of illness, disability, death, age, or length of service"); § 547(b)(2) (authorizing trustee to avoid a transfer of an interest of the debtor in property "for or on account of an antecedent debt owed by the debtor"); § 547(c)(4)(B) (barring trustee from avoiding a transfer when a creditor gives new value to the debtor "on account of which new value the debtor did not make an otherwise unavoidable transfer to ... such creditor"). So, under the commonsense rule that a given phrase is meant to carry a given concept in a single statute, see *Cohen v. De La Cruz,* 523 U.S. 213, 219-220, 118 S.Ct. 1212, 140 L.Ed.2d 341 (1998), the better reading of subsection (b)(2)(B)(ii) recognizes that a causal relationship between holding the prior claim or interest and receiving or retaining property is what activates the absolute priority rule.

The degree of causation is the final bone of contention. We understand the Government, as *amicus curiae,* to take the starchy position not only that any degree of causation between earlier interests and retained property will activate the bar to a plan providing for later property, Brief for United States as *Amicus Curiae* 11-15, but also that whenever the holders of equity in the Debtor end up with some property there will be some causation; when old equity, and not someone on the street, gets property the reason is *res ipsa loquitur.* An old equity holder simply cannot take property under a plan if creditors are not paid in full. *Id.,* at 10-11, 18. See also Tr. of Oral Arg. 28.[FN23]

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FN23. Our interpretation of the Government's position in this respect is informed by its view as *amicus curiae* in the *Bonner Mall* case: "the language and structure of the Code prohibit in all circumstances confirmation of a plan that grants the prior owners an equity interest in the reorganized debtor over the objection of a class of unpaid unsecured claims." Brief for United States as *Amicus Curiae* in *United States Bancorp Mortgage Co. v. Bonner Mall Partnership*, O.T.1993, No. 93-714, p. 14.

The Government conceded that, in the case before us, it had no need to press this more stringent view, since "whatever [the] definition of 'on account of,' a 100 percent certainty that junior equit[y] obtains property because they're junior equity will satisfy that." See Tr. of Oral Arg. 29 (internal quotation marks added).

**1421 *452 There are, however, reasons counting against such a reading. If, as is likely, the drafters were treating junior claimants or interest holders as a class at this point (see *Ahlers*, 485 U.S., at 202, 108 S.Ct. 963),[FN24] then the simple way to have prohibited the old interest holders from receiving anything over objection would have been to omit the "on account of " phrase entirely from subsection (b)(2)(B)(ii). On this assumption, reading the provision as a blanket prohibition would leave "on account of " as a redundancy, contrary to the interpretive obligation to try to give meaning to all the statutory language. See, *e.g., Moskal v. United States*, 498 U.S. 103, 109-110, 111 S.Ct. 461, 112 L.Ed.2d 449 (1990); *United States v. Menasche*, 348 U.S. 528, 538-539, 75 S.Ct. 513, 99 L.Ed. 615 (1955).[FN25] One would also have to ask why Congress *453 would have desired to exclude prior equity categorically from the class of potential owners following a cramdown. Although we have some doubt about the Court of Appeals's assumption (see 126 F.3d, at 966, and n. 12) that prior equity is often the only source of significant capital for reorganizations, see, *e.g.*, Blum & Kaplan, The Absolute Priority Doctrine in Corporate Reorganizations, 41 U. Chi. L.Rev. 651, 672 (1974); Mann, Strategy and Force in the Liquidation of Secured Debt, 96 Mich. L.Rev. 159, 182-183, 192-194, 208-209 (1997), old equity may well be in the best position to make a go of the reorganized enterprise and so may be the party most likely to work out an equity-for-value reorganization.

FN24. It is possible, on the contrary, to argue on the basis of the immediate text that the prohibition against receipt of an interest "on account of " a prior unsecured claim or interest was meant to indicate only that there is no *per se* bar to such receipt by a creditor holding both a senior secured claim and a junior unsecured one, when the senior secured claim accounts for the subsequent interest. This reading would of course eliminate the phrase "on account of " as an express source of a new value exception, but would leave open the possibility of interpreting the absolute priority rule itself as stopping short of prohibiting a new value transaction.

FN25. Given our obligation to give meaning to the "on account of " modifier, we likewise do not rely on various statements in the House Report or by the bill's floor leaders, which, when read out of context, imply that Congress intended an emphatic, unconditional absolute priority rule. See, *e.g.*, H.R.Rep. No. 95-595, p. 224 (1977), U.S.Code Cong. & Admin. News pp. 5963, 6183. ("[T]he bill requires that the plan pay any dissenting class in full before any class junior to the dissenter may be paid at all"); *id.*, at 413 ("[I]f [an impaired class is] paid less than in full, then no class junior may receive anything under the plan"); 124 Cong. Rec. 32408 (1978) (statement of Rep. Edwards) (cramdown plan confirm-

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able only "as long as no class junior to the dissenting class receives anything at all"); *id.,* at 34007 (statement of Sen. DeConcini) (same).

A less absolute statutory prohibition would follow from reading the "on account of " language as intended to reconcile the two recognized policies underlying Chapter 11, of preserving going concerns and maximizing property available to satisfy creditors, see *Toibb v. Radloff,* 501 U.S. 157, 163, 111 S.Ct. 2197, 115 L.Ed.2d 145 (1991). Causation between the old equity's holdings and subsequent property substantial enough to disqualify a plan would presumably occur on this view of things whenever old equity's later property would come at a price that failed to provide the greatest possible addition to the bankruptcy estate, and it would always come at a price too low when the equity holders obtained or preserved an ownership interest for less than someone else would have paid.[FN26] A truly full *454 value **1422 transaction, on the other hand, would pose no threat to the bankruptcy estate not posed by any reorganization, provided of course that the contribution be in cash or be realizable money's worth, just as *Ahlers* required for application of *Case* 's new value rule. Cf. *Ahlers, supra,* at 203-205, 108 S.Ct. 963; *Case,* 308 U.S., at 121, 60 S.Ct. 1.

FN26. Even when old equity would pay its top dollar and that figure was as high as anyone else would pay, the price might still be too low unless the old equity holders paid more than anyone else would pay, on the theory that the "necessity" required to justify old equity's participation in a new value plan is a necessity for the participation of old equity as such. On this interpretation, disproof of a bargain would not satisfy old equity's burden; it would need to show that no one else would pay as much. See, *e.g., In re Coltex Loop Central Three Partners, L. P.,* 138 F.3d 39, 45 (C.A.2 1998) ("[O]ld equity must be willing to contribute more money than any other source" (internal quotation marks and citation omitted)); Strub, 111 Banking L. J., at 243 (old equity must show that the reorganized entity "needs funds *from the prior owner-managers* because no other source of capital is available"). No such issue is before us, and we emphasize that our holding here does not suggest an exhaustive list of the requirements of a proposed new value plan.

IV

[3] Which of these positions is ultimately entitled to prevail is not to be decided here, however, for even on the latter view the Bank's objection would require rejection of the plan at issue in this case. It is doomed, we can say without necessarily exhausting its flaws, by its provision for vesting equity in the reorganized business in the Debtor's partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan. Although the Debtor's exclusive opportunity to propose a plan under § 1121(b) is not itself "property" within the meaning of subsection (b)(2)(B)(ii), the respondent partnership in this case has taken advantage of this opportunity by proposing a plan under which the benefit of equity ownership may be obtained by no one but old equity partners. Upon the court's approval of that plan, the partners were in the same position that they would have enjoyed had they exercised an exclusive option under the plan to buy the equity in the reorganized entity, or contracted to purchase it from a seller who had first agreed to deal with no one else. It is quite true that the escrow of the partners' proposed investment eliminated any formal need to set out an express *455 option or exclusive dealing provision in the plan itself, since the court's approval that created the opportunity and the partners' action to obtain its advantage were simultaneous. But before the Debtor's plan was accepted no one else could propose an alternative one, and after its acceptance no one else could obtain equity in the

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reorganized entity. At the moment of the plan's approval the Debtor's partners necessarily enjoyed an exclusive opportunity that was in no economic sense distinguishable from the advantage of the exclusively entitled offeror or option holder. This opportunity should, first of all, be treated as an item of property in its own right. Cf. *In re Coltex Loop Central Three Partners, L. P.*, 138 F.3d, at 43 (exclusive right to purchase post-petition equity is itself property); *In re Bryson Properties, XVIII*, 961 F.2d, at 504; *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1360 (C.A.7 1990); D. Baird, The Elements of Bankruptcy 261 (rev. ed. 1993) ("The right to get an equity interest for its fair market value is 'property' as the word is ordinarily used. Options to acquire an interest in a firm, even at its market value, trade for a positive price"). While it may be argued that the opportunity has no market value, being significant only to old equity holders owing to their potential tax liability, such an argument avails the Debtor nothing, for several reasons. It is to avoid just such arguments that the law is settled that any otherwise cognizable property interest must be treated as sufficiently valuable to be recognized under the Bankruptcy Code. See *Ahlers*, 485 U.S., at 207-208, 108 S.Ct. 963. Even aside from that rule, the assumption that no one but the Debtor's partners might pay for such an opportunity would obviously support no inference that it is valueless, let alone that it should not be treated as property. And, finally, the source in the tax law of the opportunity's value to the partners implies in no way that it lacks value to others. It might, indeed, be valuable to another precisely as a way to keep the Debtor from implementing a plan that would avoid a Chapter 7 liquidation.

*456 Given that the opportunity is property of some value, the question arises why old equity alone should obtain it, not to mention at no cost whatever. The closest thing to an answer favorable to the Debtor is that the old equity partners would be given the opportunity in the expectation that in taking advantage of it they would add the stated purchase price to the estate. See Brief for Respondent 40-41. But this just begs the question why the opportunity should be exclusive to the old equity holders. If the price **1423 to be paid for the equity interest is the best obtainable, old equity does not need the protection of exclusiveness (unless to trump an equal offer from someone else); if it is not the best, there is no apparent reason for giving old equity a bargain. There is no reason, that is, unless the very purpose of the whole transaction is, at least in part, to do old equity a favor. And that, of course, is to say that old equity would obtain its opportunity, and the resulting benefit, because of old equity's prior interest within the meaning of subsection (b)(2)(B)(ii). Hence it is that the exclusiveness of the opportunity, with its protection against the market's scrutiny of the purchase price by means of competing bids or even competing plan proposals, renders the partners' right a property interest extended "on account of " the old equity position and therefore subject to an unpaid senior creditor class's objection.

It is no answer to this to say that the exclusive opportunity should be treated merely as a detail of the broader transaction that would follow its exercise, and that in this wider perspective no favoritism may be inferred, since the old equity partners would pay something, whereas no one else would pay anything. If this argument were to carry the day, of course, old equity could obtain a new property interest for a dime without being seen to receive anything on account of its old position. But even if we assume that old equity's plan would not be confirmed without satisfying the judge that the purchase price was top dollar, there is a further reason here not to treat property consisting of an exclusive opportunity as subsumed within the total trans action*457 proposed. On the interpretation assumed here, it would, of course, be a fatal flaw if old equity acquired or retained the property interest without paying full value. It would thus be necessary for old equity to demonstrate its payment of top dollar, but this it could not satisfactorily do when it would receive or retain its property under a plan giving it exclusive rights and in the absence of

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a competing plan of any sort.FN27 Under a plan granting an exclusive right, making no provision for competing bids or competing plans, any determination that the price was top dollar would necessarily be made by a judge in bankruptcy court, whereas the best way to determine value is exposure to a market. See Baird, Elements of Bankruptcy, at 262; Bowers, Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses, 72 Wash. U.L.Q. 955, 959, 963, n. 34, 975 (1994); Markell, 44 Stan. L.Rev., at 73 ("Reorganization practice illustrates that the presence of competing bidders for a debtor, whether they are owners or not, tends to increase creditor dividends"). This is a point of some significance, since it was, after all, one of the Code's innovations to narrow the occasions for courts to make valuation judgments, as shown by its preference for the supramajoritarian class creditor voting scheme in § 1126(c), see *Ahlers, supra,* at 207, 108 S.Ct. 963 ("[T]he Code provides that it is up to the creditors-and not the courts-to accept or reject a reorganization plan which fails to provide them adequate protection or fails to honor the absolute priority rule").FN28 In the **1424 interest of statutory coherence, a like disfavor*458 for decisions untested by competitive choice ought to extend to valuations in administering subsection (b)(2)(B)(ii) when some form of market valuation may be available to test the adequacy of an old equity holder's proposed contribution.

FN27. The dissent emphasizes the care taken by the Bankruptcy Judge in examining the valuation evidence here, in arguing that there is no occasion for us to consider the relationship between valuation process and top-dollar requirement. *Post,* at 1428, n. 7. While we agree with the dissent as to the judge's conscientious handling of the matter, the ensuing text of this opinion sets out our reasons for thinking the Act calls for testing valuation by a required process that was not followed here.

FN28. In *Ahlers*, we explained: "The Court of Appeals may well have believed that petitioners or other unsecured creditors would be better off if respondents' reorganization plan was confirmed. But that determination is for the creditors to make in the manner specified by the Code. 11 U.S.C. § 1126(c). Here, the principal creditors entitled to vote in the class of unsecured creditors (*i.e.,* petitioners) objected to the proposed reorganization. This was their prerogative under the Code, and courts applying the Code must effectuate their decision." 485 U.S., at 207, 108 S.Ct. 963. The voting rules of Chapter 11 represent a stark departure from the requirements under the old Act. "Congress adopted the view that creditors and equity security holders are very often better judges of the debtor's economic viability and their own economic self-interest than courts, trustees, or the SEC.... Consistent with this new approach, the Chapter 11 process relies on creditors and equity holders to engage in negotiations toward resolution of their interests." Brunstad, Sigal, & Schorling, Review of the Proposals of the National Bankruptcy Review Commission Pertaining to Business Bankruptcies: Part One, 53 Bus. Law. 1381, 1406, n. 136 (1998).

[4] Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity is a question we do not decide here. It is enough to say, assuming a new value corollary, that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).

The judgment of the Court of Appeals, accordingly, is reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

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Justice THOMAS, with whom Justice SCALIA joins, concurring in the judgment.

I agree with the majority's conclusion that the reorganization plan in this case could not be confirmed. However, I do *459 not see the need for its unnecessary speculations on certain issues and do not share its approach to interpretation of the Bankruptcy Code. I therefore concur only in the judgment.

I

Our precedents make clear that an analysis of any statute, including the Bankruptcy Code, must not begin with external sources, but with the text itself. See, *e.g., Connecticut Nat. Bank v. Germain*, 503 U.S. 249, 253-254, 112 S.Ct. 1146, 117 L.Ed.2d 391 (1992); *Union Bank v. Wolas*, 502 U.S. 151, 154, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991). The relevant Code provision in this case, 11 U.S.C. § 1129(b), does not expressly authorize prepetition equity holders to receive or retain property in a reorganized entity in exchange for an infusion of new capital.[FN1] Instead, it is cast in general terms and requires that, to be confirmed over the objections of an impaired class of creditors, a reorganization plan be "fair and equitable." § 1129(b)(1). With respect to an impaired class of unsecured creditors, a plan can be fair and equitable only if, at a minimum, it "provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim," § 1129(b)(2)(B)(i), or if "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property," § 1129(b)(2)(B)(ii).

FN1. In this respect, § 1129 differs from other provisions of the Code, which permit owners to retain property before senior creditors are paid. See, *e.g.*, 11 U.S.C. § 1225(b)(1)(B) (allowing a debtor to retain nondisposable income); § 1325(b)(1)(B) (same).

Neither condition is met here. The bank did not receive property under the reorganization plan equal to the amount of its unsecured deficiency claim. See *ante*, at 1414-1415. Therefore, the plan could not satisfy the first condition. With respect to the second condition, the prepetition equity holders *460 received at least two forms of property under the plan: the exclusive opportunity to obtain equity, *ante*, at 1422-1424, and an equity interest in the reorganized entity. The plan could not be confirmed if the prepetition equity holders received any of this property "on account of " their junior interest.

The meaning of the phrase "on account of " is the central interpretive question presented by this case. This phrase obviously denotes some type of causal relationship between the junior interest and the property received or retained-such an interpretation comports with common understandings of the phrase. See, *e.g.*, Random House Dictionary of the English Language 13 (2d ed.1987) ("by reason of," "because of "); Webster's Third New International Dictionary 13 (1976) ("for the sake of," "by reason of," "because of "). It also tracks the use of the phrase elsewhere in **1425 the Code. See, *e.g.*, 11 U.S.C. §§ 365(f)(3), 510(b), 1111(b)(1)(A); see generally § 1129. Regardless of how direct the causal nexus must be, the prepetition equity holders here undoubtedly received at least one form of property-the exclusive opportunity-"on account of " their prepetition equity interest. *Ante*, at 1422. Since § 1129(b)(2)(B)(ii) prohibits the prepetition equity holders from receiving "any" property under the plan on account of their junior interest, this plan was not "fair and equitable" and could not be confirmed. That conclusion, as the majority recognizes, *ibid.*, is sufficient to resolve this case. Thus, its comments on the Government's position taken in another case, *ante*, at 1420-1422, and its speculations about the desirability of a "market test," *ante*, at 1423-1424, are dicta binding neither this Court nor the lower federal courts.

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II

The majority also underestimates the need for a clear method for interpreting the Bankruptcy Code. It extensively surveys pre-Code practice and legislative history, *ante,* at 1417-1419, but fails to explain the relevance of these sources to the interpretive question apart from the conclusoryassertion ***461** that the Code's language is "inexact" and the history is "helpful," *ante,* at 1417. This sort of approach to interpretation of the Bankruptcy Code repeats a methodological error committed by this Court in *Dewsnup v. Timm,* 502 U.S. 410, 112 S.Ct. 773, 116 L.Ed.2d 903 (1992).

In *Dewsnup,* the Court held, based on pre-Code practice, that § 506(d) of the Code prevented a Chapter 7 debtor from stripping down a creditor's lien on real property to the judicially determined value of the collateral. *Id.,* at 419-420, 112 S.Ct. 773. The Court justified its reliance on such practice by finding the provision ambiguous. *Id.,* at 416, 112 S.Ct. 773. Section 506 was ambiguous, in the Court's view, simply because the litigants and *amici* had offered competing interpretations of the statute. *Ibid.* This is a remarkable and untenable methodology for interpreting any statute. If litigants' differing positions demonstrate statutory ambiguity, it is hard to imagine how any provision of the Code-or any other statute-would escape *Dewsnup's* broad sweep. A mere disagreement among litigants over the meaning of a statute does not prove ambiguity; it usually means that one of the litigants is simply wrong. *Dewsnup's* approach to statutory interpretation enables litigants to undermine the Code by creating "ambiguous" statutory language and then cramming into the Code any good idea that can be garnered from pre-Code practice or legislative history.

The risks of relying on such practice in interpreting the Bankruptcy Code, which seeks to bring an entire area of law under a single, coherent statutory umbrella, are especially weighty. As we previously have recognized, the Code "was intended to modernize the bankruptcy laws, and as a result made significant changes in both the substantive and procedural laws of bankruptcy." *United States v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 240, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989) (citation omitted). The Code's overall scheme often reflects substantial departures from various pre-Code practices. Most relevant to this case, the Code created a system of creditor class approval***462** of reorganization plans, unlike early pre-Code practice where plan confirmation depended on unanimous creditor approval and could be hijacked by a single holdout. See D. Baird, The Elements of Bankruptcy 262 (rev. ed. 1993). Hence it makes little sense to graft onto the Code concepts that were developed during a quite different era of bankruptcy practice.

Even assuming the relevance of pre-Code practice in those rare instances when the Code is truly ambiguous, see, *e.g., Midlantic Nat. Bank v. New Jersey Dept. of Environmental Protection,* 474 U.S. 494, 501, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986), and assuming that the language here is ambiguous, surely the sparse history behind the new value exception cannot inform the interpretation of § 1129(b)(2)(B)(ii). No holding of this Court ever embraced the new value exception. As noted by the majority, *ante,* at 1417, the leading decision suggesting this possibility, *Case v. Los Angeles Lumber Products Co.,* 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110 (1939), did so in dictum. And, prior to the Code's enactment, no court ever ****1426** relied on the *Case* dictum to approve a plan. Given its questionable pedigree prior to the Code's enactment, a concept developed in dictum and employed by lower federal courts only *after* the Code's enactment is simply not relevant to interpreting this provision of the Code.[FN2]

FN2. Nor do I think that the history of rejected legislative proposals bears on the proper interpretation of the phrase "on account of." As an initial matter, such history is irrelevant for the simple reason that Congress enacted the Code, not the legislative history predating it. See *United*

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States v. Estate of Romani, 523 U.S. 517, 535-537, 118 S.Ct. 1478, 140 L.Ed.2d 710 (1998) (SCALIA, J., concurring in part and concurring in judgment). Even if this history had some relevance, it would not support the view that Congress intended to insert a new value exception into the phrase "on account of." On the contrary, Congress never acted on bills that would have allowed nonmonetary new value contributions. *Ante,* at 1418.

This danger inherent in excessive reliance on pre-Code practice did not escape the notice of the dissenting Justices in *Dewsnup* who expressed "the greatest sympathy for the Courts of Appeals who must predict which manner of statutory*463 construction we shall use for the next Bankruptcy Code case." *Dewsnup, supra,* at 435, 112 S.Ct. 773 (SCALIA, J., joined by SOUTER, J., dissenting). Regrettably, subsequent decisions in the lower courts have borne out the dissenters' fears. The methodological confusion created by *Dewsnup* has enshrouded both the Courts of Appeals and, even more tellingly, Bankruptcy Courts, which must interpret the Code on a daily basis.[FN3] In the wake of *Dewsnup,* the Fifth Circuit withdrew its decision on the new value exception, prompting the author of the original opinion to observe that *Dewsnup* had clouded "[h]ow one should approach issues of a statutory construction arising from the Bankruptcy Code." *In re Greystone III Joint Venture,* 995 F.2d 1274, 1285 (C.A.5 1991) (Jones, J., dissenting). Unfortunately, the approach taken today only thickens the fog.

FN3. See, *e.g., In re Southeast Banking Corp.,* 156 F.3d 1114, 1123, n. 16 (C.A.11 1998); *In re Greystone III Joint Venture,* 995 F.2d 1274 (C.A.5 1991) (*per curiam*) (vacating prior panel decision regarding new value exception apparently in light of *Dewsnup*); 995 F.2d, at 1285 (Jones, J., dissenting); *In re Kirchner,* 216 B.R. 417, 418 (Bkrtcy.W.D.Wis.1997); *In re Bowen,* 174 B.R. 840, 852-853 (Bkrtcy.S.D.Ga.1994); *In re Dever,* 164 B.R. 132, 138 (Bkrtcy.C.D.Cal.1994); *In re Mr. Gatti's, Inc.,* 162 B.R. 1004, 1010 (Bkrtcy.W.D.Tex.1994); *In re Taffi,* 144 B.R. 105, 112-113 (Bkrtcy.C.D.Cal.1992), rev'd, 72 A.F.T.R.2d ¶ 93-5408, p. 93-6607 (CD Cal.1993), aff'd. in part and rev'd in part, 68 F.3d 306 (C.A.9 1995), aff'd. as modified, 96 F.3d 1190 (C.A.9 1996) (en banc), cert. denied, 521 U.S. 1103, 117 S.Ct. 2478, 138 L.Ed.2d 987 (1997); *In re A.V.B.I., Inc.,* 143 B.R. 738, 744-745 (Bkrtcy.C.D.Cal.1992), holding rejected by *In re Bonner Mall Partnership,* 2 F.3d 899, 912-913 (C.A.9 1993), cert. granted, 510 U.S. 1039, 114 S.Ct. 681, 126 L.Ed.2d 648, vacatur denied and appeal dism'd as moot, 513 U.S. 18, 115 S.Ct. 386, 130 L.Ed.2d 233 (1994).

Justice STEVENS, dissenting.

Prior to the enactment of the Bankruptcy Reform Act of 1978, this Court unequivocally stated that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor if their participation is based on a contribution in money, or in money's worth, reasonably equivalent in view of all the circumstances *464 to their participation.[FN1] As we have on two prior occasions,[FN2] we granted certiorari in this **1427 case to decide whether 11 U.S.C. § 1129(b)(2)(B)(ii) of the 1978 Act preserved or repealed this "new value" component of the absolute priority rule. I believe the Court should now definitively resolve the question and state that a holder of a junior claim or interest does not receive property "on account of " such a claim when its participation in the plan is based on adequate new value.

FN1. As Justice Douglas explained in *Case v. Los Angeles Lumber Products Co.,* 308 U.S. 106, 121-122, 60 S.Ct. 1, 84 L.Ed. 110 (1939) (footnote omitted):

"It is, of course, clear that there are cir-

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cumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor. This Court, as we have seen, indicated as much in *Northern Pacific Ry. Co.* v. *Boyd* [, 228 U.S. 482, 33 S.Ct. 554, 57 L.Ed. 931 (1913),] and *Kansas City Terminal Ry. Co. v. Central Union Trust Co.* [, 271 U.S. 445, 46 S.Ct. 549, 70 L.Ed. 1028 (1926)]. Especially in the latter case did this Court stress the necessity, at times, of seeking new money 'essential to the success of the undertaking' from the old stockholders. Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made....

"In view of these considerations we believe that to accord 'the creditor his full right of priority against the corporate assets' where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder."

FN2. See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 203, n. 3, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988); *U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership*, 513 U.S. 18, 115 S.Ct. 386, 130 L.Ed.2d 233 (1994).

The Court today wisely rejects the Government's "starchy" position that an old equity holder can never receive an interest in a reorganized venture as a result of a cramdown unless the creditors are first paid in full. *Ante*, at 1420.[FN3] Nevertheless, I find the Court's objections to the plan *465 before us unsupported by either the text of § 1129(b)(2)(B)(ii) or the record in this case. I would, therefore, affirm the judgment of the Court of Appeals.

FN3. As I noted earlier, see n. 1, *supra*, Justice Douglas made this proposition clear in *Case v. Los Angeles*, *supra*. Justice Douglas was a preeminent bankruptcy scholar, well known for his views on the dangers posed by management-controlled corporate reorganizations. Both his work on the Protective Committee Study for the Securities and Exchange Commission and on Chapter X of the Bankruptcy Act sought to "restore the integrity of the reorganization process" which "too often [was] masterminded from behind the scenes by reorganization managers allied with the corporation's management or its bankers." Jennings, Mr. Justice Douglas: His Influence on Corporate and Securities Regulation, 73 Yale L.J. 920, 935-937 (1964). To this end, Douglas placed special emphasis on the protection of creditors' rights in reorganizations. Hopkirk, William O. Douglas-His Work in Policing Bankruptcy Proceedings, 18 Vand. L.Rev. 663, 685 (1965). I find it implausible that Congress, in enacting the Bankruptcy Code, intended to be even more strict than Justice Douglas in limiting the ability of debtors to participate in reorganizations.

I

Section 1129 of Chapter 11 sets forth in detail the substantive requirements that a reorganization plan must satisfy in order to qualify for confirmation.[FN4] In the case of dissenting creditor classes, a plan must conform to the dictates of § 1129(b). With only one exception, the requirements of §§ 1129(a) and 1129(b) are identical for plans submitted by stockholders or junior creditors and plans submitted by other parties. That exception is the requirement in § 1129(b)(2)(B)(ii) that no holder of a junior claim or interest may receive or retain any property "on account of such junior claim or in-

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terest."

FN4. "Confirmation of a plan of reorganization is the statutory goal of every chapter 11 case. Section 1129 provides the requirements for such confirmation, containing Congress' minimum requirements for allowing an entity to discharge its unpaid debts and continue its operations." 7 Collier on Bankruptcy ¶ 1129.01, p. 1129-10 (rev. 15th ed.1998).

When read in the light of Justice Douglas' opinion in *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110 (1939), the meaning of this provision is perfectly clear. Whenever a junior claimant receives or retains an interest for a bargain price, it does so "on account of " its prior claim. On the other *466 hand, if the new capital that it invests has an equivalent or greater value than its interest in the reorganized venture, it should be equally clear that its participation is based on the fair price being paid and that it is not "on account of " its old claim or equity.

Of course, the fact that the proponents of a plan offer to pay a fair price for the interest they seek to acquire or retain does not necessarily mean that the bankruptcy judge should approve their plan. Any proposed cramdown must satisfy all of the requirements of § 1129 including, most notably, the requirement that the plan be "fair and equitable" to all creditors whose claims are impaired. See § 1129(b)(1). Moreover, even if the old stockholders propose to buy the debtor for a fair price, presumably their plan should not be approved if a third party, perhaps motivated by unique tax or competitive considerations, is willing to pay an even higher price. Cf. § 1129(c).

In every reorganization case, serious questions concerning the value of the debtor's assets must be resolved.[FN5] Nevertheless, for **1428 the purpose of answering the legal question presented by the parties to this case, I believe that we should assume that all valuation questions have been correctly answered. If, for example, there had been a widely advertised auction in which numerous bidders participated, and if the plan proposed by respondents had been more favorable by a wide margin than any competing proposal, would § 1129(b)(2)(B)(ii) require rejection of their plan simply because it provides that they shall retain 100% of the equity?

FN5. See Warren, A Theory of Absolute Priority, 1991 Ann. Survey Am. L. 9, 13 ("In practice, no problem in bankruptcy is more vexing than the problem of valuation").

Petitioner and the Government would reply "yes" because they think § 1129(b)(2)(B)(ii) imposes an absolute ban on participation by junior claimants without the consent of all senior creditors. The Court correctly rejects this extreme position because it would make the words "on account of " *467 superfluous, and because there is no plausible reason why Congress would have desired such a categorical exclusion, given that in some cases old equity may be the most likely source of new capital. See *ante*, at 1421. Indeed, the dissenting judge in the Court of Appeals thought "such a result would border on the absurd."[FN6] Thus, neither the dissenting judge in the Court of Appeals nor the Court appears to be in doubt about the proper answer to my hypothetical question. Instead, the decision is apparently driven by doubts concerning the procedures followed by the Bankruptcy Judge in making his value determinations, implicitly suggesting that the statute should be construed to require some form of competitive bidding in cases like this.[FN7] See *ante*, at 1422-1424.

FN6. Judge KANNE wrote in dissent: "Perhaps the majority's reasoning is driven by the fear that a 'but for ' interpretation would prevent old equity from ever participating in a reorganized entity-something Congress could never have intended. Indeed, such a result would border on the absurd, but a simpler, 'but for ' causation requirement would not preclude junior in-

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terests from participating in a reorganized entity. If prior equity holders earn their shares in an open auction, for example, their received interests would not be 'on account of ' their junior interests but 'on account of ' their capital contributions." *In re 203 N. LaSalle Street Partnership,* 126 F.3d 955, 972 (C.A.7 1997).

It would seem logical for adherents of this view also to find participation by junior interests in the new entity not "on account of " their prior interest, if it were stipulated that old equity's capital contributions exceeded the amount attainable in an auction, or if findings to that effect were not challenged.

FN7. This doubt is unwarranted in this case. The bank does not challenge the Bankruptcy Court's finding that the 15 floors of office space had a market value of $55.8 million. The bank's original expert testimony on the value of the property differed from the Bankruptcy Judge's finding by only 2.8%. *In re 203 N. LaSalle Street Partnership,* 190 B.R. 567, 573-576 (Bkrtcy.N.D.Ill.1995). Therefore, although the bank argues that the policy implications of the "new value debate" revolve around judicial determinations of the valuation of the relevant collateral, Brief for Petitioner 5, n. 2, this concern was neither squarely presented in this case nor preserved for our review.

Perhaps such a procedural requirement would be a wise addition to the statute, but it is surely not contained in the *468 present text of § 1129(b)(2)(B)(ii). Indeed, that subsection is not a procedural provision at all. Section 1129 defines the substantive elements that must be met to render plans eligible for confirmation by the bankruptcy judge after all required statutory procedures have been completed. Cf. § 1121 (Who may file a plan); § 1122 (Classification of claims or interests); § 1125 (Postpetition disclosure and solicitation); § 1126 (Acceptance of plan); § 1127 (Modification of plan). Because, as I discuss below, petitioner does not now challenge either the procedures followed by the Bankruptcy Judge or any of his value determinations, neither the record nor the text of § 1129(b)(2)(B)(ii) provides any support for the Court's disposition of this case.

II

As I understand the Court's opinion, it relies on two reasons for refusing to approve the plan at this stage of the proceedings: one based on the plan itself and the other on the confirmation procedures followed before the plan was adopted. In the Court's view, the fatal flaw in the plan proposed by respondent was that it vested complete ownership in the former partners immediately upon confirmation, *ante,* at 1422, and the defect in the process was that no other party had an opportunity to propose a competing plan.

These requirements are neither explicitly nor implicitly dictated by the text of the **1429 statute. As for the first objection, if we assume that the partners paid a fair price for what the Court characterizes as their "exclusive opportunity," I do not understand why the retention of a 100% interest in assets is any more "on account of " their prior position than retaining a lesser percentage might have been. Surely there is no legal significance to the fact that immediately after the confirmation of the plan "the partners were in the same position that they would have enjoyed had they exercised an exclusive option under the plan to buy the equity *469 in the reorganized entity, or contracted to purchase it from a seller who had first agreed to deal with no one else." *Ibid.*

As to the second objection, petitioner does not challenge the Bankruptcy Judge's valuation of the property or any of his other findings under § 1129 (other than the plan's compliance with § 1129(b)(2)(B)(ii)). Since there is no remaining question as to value,

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both the former partners (and the creditors, for that matter) are in the same position that they would have enjoyed if the Bankruptcy Court had held an auction in which this plan had been determined to be the best available. That the court did not hold such an auction should not doom this plan, because no such auction was requested by any of the parties, and the statute does not require that an auction be held. As with all the provisions of § 1129, the question of compliance with § 1129(b)(2)(B)(ii) turns on the substantive content of the plan, not on speculation about the procedures that might have preceded its confirmation.

In this case, the partners had the exclusive right to propose a reorganization plan during the first 120 days after filing for bankruptcy. See § 1121(b). No one contends that that exclusive right is a form of property that is retained by the debtor "on account of " its prior status.[FN8] The partners did indeed propose a plan which provided for an infusion of $6.125 million in new capital in exchange for ownership of the reorganized debtor. Since the tax value of the partnership depended on their exclusive participation, it is unsurprising that the partners' plan did not propose that unidentified outsiders should also be able to own an unspecified portion of the reorganized partnership. It seems both practically and economically puzzling to assume that Congress would have expected old equity to provide for the participation*470 of unknown third parties, who would have interests different from (and perhaps incompatible with) the partners', in order to comply with § 1129(b)(2)(B)(ii).[FN9]

FN8. Indeed, as the Court acknowledges, *ante*, at 1422, it is not "property" within the meaning of the Act.

FN9. It goes without saying that Congress could not have expected the partners' plan to include a provision that would allow for the Bankruptcy Judge to entertain competing plans, since that is a discretionary decision exclusively within the province of the court. See § 1121(d).

Nevertheless, even after proposing their plan, the partners had no vested right to purchase an equity interest in the postreorganization enterprise until the Bankruptcy Judge confirmed the plan. They also had no assurance that the court would refuse to truncate the exclusivity period and allow other interested parties to file competing plans. As it turned out, the Bankruptcy Judge did not allow respondent to file its proposed plan, but the bank did not appeal that issue, and the question is not before us.[FN10]

FN10. Apparently, the bank's plan called for liquidation of the property. In order to flesh out all facts bearing on value, perhaps the Bankruptcy Judge should have terminated the exclusivity period and allowed the bank to file its plan. That the bank's plan called for liquidation of the property in a single-asset context does not necessarily contravene the purposes of Chapter 11. See, *e.g., In re River Village Associates,* 181 B.R. 795, 805 (E.D.Pa.1995).

The moment the judge did confirm the partners' plan, the old equity holders were required by law to implement the terms of the plan.[FN11] It was then, and only then, that what *471 the Court characterizes as the critical "exclusive opportunity" came into existence. What the Court refuses to recognize, **1430 however, is that this "exclusive opportunity" is the function of the procedural features of this case: the statutory exclusivity period, the Bankruptcy Judge's refusal to allow the bank to file a competing plan, and the inescapable fact that the judge could confirm only one plan.

FN11. Section 1141(a) states: "Except as provided in subsections (d)(2) and (d)(3) of this section, the provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity

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> security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan."

> See 8 Collier on Bankruptcy ¶ 1141.02, at 1141-4 to 1141-5 ("Section 1141(a) of the Code provides that a plan is binding upon all parties once it is confirmed. Under this provision, subject to compliance with the requirements of due process under the Fifth Amendment, a confirmed plan is binding upon every entity that holds a claim or interest ..."); see also § 1142(a).

> In this case, the plan provided: "The general partners and limited partners of the Reorganized Debtor shall contribute or cause to be contributed $6.125 million of new capital (the 'New Capital') to the Reorganized Debtor as follows: $3.0 million in cash ('Initial Capital') on the first business banking day after the Effective Date, and $625,000 on each of the next five anniversaries of the Effective Date." App. 38-39. The "Effective Date" of the plan was defined as "[t]he first business day after the Confirmation Order is entered on the docket sheet maintained for the Case." *Id.,* at 24.

The Court's repeated references to the partners' "opportunity," see *ante,* at 1422, 1423, is potentially misleading because it ignores the fact that a plan is binding upon all parties once it is confirmed. One can, of course, refer to contractual rights and duties as "opportunities," but they are not separate property interests comparable to an option that gives its holder a legal right either to enter into a contract or not to do so. They are simply a part of the bundle of contractual terms that have legal significance when a plan is confirmed.

When the court approved the plan, it accepted an offer by old equity. If the value of the debtor's assets has been accurately determined, the fairness of such an offer should be judged by the same standard as offers made by newcomers. Of course, its offer should not receive more favorable consideration "on account of " their prior ownership. But if the debtor's plan would be entitled to approval if it had been submitted by a third party, it should not be disqualified simply because it did not include a unique provision that would *472 not be required in an offer made by any other party, including the creditors.

Since the Court of Appeals correctly interpreted § 1129(b)(2)(B)(ii), its judgment should be affirmed.

Accordingly, I respectfully dissent.

U.S.Ill.,1999.
Bank of America Nat. Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership
526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed.2d 607, 67 USLW 4275, 41 Collier Bankr.Cas.2d 526, 34 Bankr.Ct.Dec. 329, Bankr. L. Rep. P 77,924, 99 Cal. Daily Op. Serv. 3158, 1999 Daily Journal D.A.R. 4132, 11 Fourth Cir. & D.C. Bankr. 316, 1999 CJ C.A.R. 2439, 12 Fla. L. Weekly Fed. S 216, 16 Colo. Bankr. Ct. Rep. 65, 3 Cal. Bankr. Ct. Rep. 34

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TAB "9"

Do Stalking Horses Have a Place in Intra-Canadian Insolvencies?

*Daniel R. Dowdall and Jane O. Dietrich**

I. INTRODUCTION

Asset sales in Canadian insolvency proceedings have normally been accomplished through a tender-type process, as opposed to asset sales in U.S. insolvencies that involve auction, often preceded by the approval of a stalking-horse bid.[1] While stalking-horse bidding processes have been used in numerous cross-border situations in order to harmonize sale proceedings, in the recent *Stelco*[2] case the court authorized a stalking-horse procedure to serve as an initial bid and as a precursor to the usual tender-type procedure, thus squarely raising the issue of when stalking-horse bids may be appropriate in wholly intra-Canadian proceedings.

This article will describe both the U.S. auction process and the Canadian tender-type process as they function in an insolvency context. Although the benefits of tender as opposed to auction in obtaining the highest price can be much debated, in an insolvency context a question of equal importance arises involving the minimization of the potential for manipulation of the process. As such, we also discuss the issues related to manipulation of each process with a particular focus upon whether limiting the granting of approval of certain types

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1 The term "stalking horse" was originally a hunting term that referred to a horse trained to conceal a hunter as the horse and hunter moved closer to the prey, thereby allowing the hunter to get much closer to the prey while the horse acted as a decoy. In U.S. insolvency proceedings today, a stalking-horse bid is the initial bid in an auction that competing bidders must exceed, usually by stipulated minimum increments.

2 *Stelco Inc., Re* (2004), 2004 CarswellOnt 5076 (Ont. S.C.J. [Commercial List]).

of agreements to a stalking-horse basis can be an effective tool to prevent manipulation and achieve a higher overall value for all stakeholders.

As is explained below, in Canada, it is the authors' view that there is a growing concern with our tender-type process when the process is run by a debtor in possession. Until relatively recent times, asset sales in insolvencies were conducted by licensed trustees or receivers, and, as such, the integrity of the process was not a significant issue, given the role of the trustee or receiver as a court officer. However, in the last decade as more and more sales are being conducted in proceedings under the *Companies' Creditors Arrangement Act*[3] (CCAA) and are, therefore, if not controlled, at least shaped by the debtor itself, concerns about the integrity of the process are becoming more apparent. Although the court-appointed monitor oversees and reports to the court on the process, many critical decisions are made by the debtor, and, therefore, concerns that did not arise in receivership sales (i.e., the inclusion of management incentives or the shopping of bids by the debtor) are becoming of much greater concern. This should not be surprising. The name of the game in insolvency is control. To the extent that the debtor stays in control of the process, it should not be surprising that those who control the debtor will attempt to use their position to promote their agenda such that issues of fair process may surface, which did not arise when the process was under more neutral control.

Time constraints or potential manipulation will create situations where the court is presented with a "Hobson's Choice", in that it will be asked to approve an agreement despite the fact that there may be concerns about the adequacy of the canvassing of the market or as to potential manipulation of the process by a stakeholder. In such a case, the court's only option may be to approve the available arrangement, as otherwise operations may cease. Below, we suggest that the court should, in such circumstances, consider adopting a practice whereby whenever the court is in this type of situation and cannot be satisfied that a transaction itself or the process through which it has been reached is both fair and represents a complete canvas of the market, the court should consider limiting its approval of the arrangement to that of a stalking horse only, such that the debtor company remains open (and bound) to seek and accept higher or better bids. Wide adoption of such a practice would create incentives for all parties to proposed transactions to ensure a fair and complete process prior to seeking court approval in order to avoid a more limited approval.

As well, approval of a bid on a stalking-horse basis can be used, as it purportedly was used in *Stelco*, where there is an urgent need to create stability within a time framework that is shorter than what is required for an adequate sales process. In such situations, one would expect to see break fees and other economic incentives (as discussed below) as the price of creating such stability. It is also suggested that this approach could apply not only to agreements of purchase and sale, but also to other agreements approved by the court in an

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3 *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended.

insolvency proceeding, including the approval of DIP financing and liquidation and advisory agreements.

II. THE U.S. "AUCTION" PROCESS

The defining feature of an auction is its open nature. All bidders are aware of the other bidders' bid terms and conditions. At its basic level, an auction requires that subsequent bidders exceed the terms of the previous bid. At the end of the auction, the highest bidder is successful, and other bidders have had the opportunity to make a definitive choice as to whether or not to win the bid. In effect, every unsuccessful bidder makes a choice not to buy. There are, however, numerous variations in the auction process. For example, auction protocols may restrict bidding to previously determined qualified bidders, require minimum bid increments, or provide a stalking-horse bidder with a right of first refusal over any other successful bid.

In the U.S. bankruptcy process, assets are sold using an auction process that most often commences with a stalking-horse bid. There are, consequently, two stages of competition: first, to become the stalking-horse bidder and, second, to become the successful bidder. At both stages, concerns about manipulation exist and, to the extent that a stalking-horse bidder shapes the second round of the auction, controls should be exercised at the first stage of competition to ensure a fair process in the second.

American commentary suggests that a stalking-horse bid is necessary to start the auction but provides many cautions about the stalking-horse bid shaping the auction and otherwise manipulating the sales process.[4] Concerns specific to stalking-horse bids include the payment of break-up fees, various restrictions being placed on the debtor by the terms of the bid with respect to its ability to freely pursue competing bids (such as restraints on its ability to have discussions with other potential purchasers), and the amount that the stalking-horse bid influences or shapes the subsequent bidding process (i.e., the form of offer required and auction timelines). As we will discuss later in this

4 For example, see J. Robert Stole, Amy S. Karte, Sajida A. Ahdi, *Maximizing Disposition Value Through the "Stalking Horse" Bidding Process*, 2004 21 Nat'l Insolv. Rev 33; C. R. Bowles, John Egan, *The Sale of the Century or a Fraud on Creditors: The Fiduciary Duty of Trustees and Debtors in Possession Relating to the "Sale" of a Debtor's Assets in Bankruptcy*, Spring 1998, 28 U. Mem. L. Rev. 781; Debra I. Grassgreen, Laura Davis Jones, James H.M. Sprayregen, and James A. Stempel, *Who Wins in the Race to Get Break-up Fees Approved?* October 2003, 22-8 ABIJ 16; D. Peress: *Breaking Up Is Hard to Do*, February 2001 20-1 ABIJ 25; and Robert J. Keach, *Stalking-horse Lenders and Good Faith: The Availability of Appellate Protection under §§ 363(m) and 364(e) for Asset Purchasers Extending DIP Financing*, June 2004, 23-5 ABIJ 28.

article, concerns about manipulation of the sales process are not restricted to the auction process and are equally applicable to the tender-type process generally used in Canada.

III. THE CANADIAN "TENDER TYPE" PROCESS

In contrast to an auction, the defining feature of a tender-sales process is its closed nature. Bidders are typically given a specific period to put forth their best bid, and bids are submitted without knowledge of other bidders' bids. This secrecy theoretically encourages each bidder to submit their highest and best bid in hopes of succeeding and not losing to a competing bid that is only slightly higher. While the advocates of auctions focus upon the fact that an auction is best at squeezing the very last cent out of bidders when the asset is keenly pursued by multiple motivated parties, where there is a limited market, the auction process can also act to ensure that a bidder who is intent on buying pays the minimum that it must, while by contrast, in a tender, the same purchaser might be inclined to bid much higher because it will have no assurance about the amount of competing bids.

In a tender or tender-type process, controls are put in place to ensure secrecy of bids. However, as the process has evolved in the Canadian insolvency context, formal tender has morphed into something less. Typically, bidding procedures simply call for the receipt of letters of intent or offers, which may or may not be binding, by a certain deadline. The party conducting the sale will usually select some subset of the offers for further negotiation. Even when dealing with neutral parties, such as receivers or trustees, bidders express concern about whether there are some elements of bid shopping. This is all the more the case where the sale is conducted by the debtor corporation and when a sale process is running parallel and in competition with an investment process. Although Canadian courts have clearly held that bankruptcy trustees have a duty to maintain secrecy of the bids in order to ensure the integrity of the bidding process and that trustees are not permitted to shop bids,[5] the extent that this "no shop duty" extends to debtors who control the sales process in a restructuring is not clear, and, in practice, there is growing concern among bidders about the fairness of debtor-run sales processes.

As well, it should be remembered that not all sales of assets in a Canadian insolvency context proceed through a tender process. This is most especially apparent with pre-packaged plans where the debtor has canvassed the market and substantially finalized the agreement prior to the insolvency filing and then comes to court seeking approval of the sale.

5 See *Pretty Fashion Inc., Re* (1951), 31 C.B.R. 217 (Que. S.C.).

A tender process, like an auction, is subject to manipulation. As discussed below, many of the same manipulation concerns regarding timelines and decision making exist in both processes. However, as will be discussed in more detail below, the most significant concern that exists with a tender process and not in an auction process is the shopping of bids and the related process-integrity issues. Bid shopping effectively turns a tender into an auction, so the bidder gets the worst of both worlds. In an auction, the bidder, while knowing that it will have to pay the highest price that the market will demand, has the comfort of knowing that it will pay no more than the market requires. In a tender, the bidder has to pay what it perceives the market to be, which may prove to be much more than what it could have paid at auction, while if there are competing bids and the bids are shopped, it will end up having to have its price bid up by those with lower bids who did not take as much risk on the lower side of the equation.

IV. MANIPULATION OF AUCTIONS AND TENDERS

No sales process is immune to manipulation by interested parties. Any party who has an interest in the outcome and has some elementary control will be tempted to manipulate the process to dictate an outcome that is to its advantage.

The important question, therefore, becomes whether particular types of sales processes are more or less susceptible to manipulation in certain conditions. In other words, are there situations in which a stalking-horse/auction process is less subject to manipulation than a tender-type process, or vice versa?

In order to answer this question, the potentials for manipulation must be examined. As we will discuss, the primary ways that an interested party can manipulate the process can be broken down into two general categories: economic and control incentives.

Although these incentives are traditionally discussed in relation to a sale of assets of a company, consideration should also be given to these concerns in the context of debtor-in-possession (DIP) financing or other contracts entered into during the proceedings.

1. Economic Incentives

Various economic restraints through which an interested party can influence a sale process have been examined in detail in U.S. literature as they apply to stalking-horse processes and will be summarized here. For the most part, these economic incentives do not apply in a tender process and are unique to a stalking-horse/auction process.

(a) Break fees

Often, a break fee may be incorporated into a stalking-horse bid. Although variations of break-fee arrangements exist, typically such a fee would become payable to the potential purchaser if their bid does not become the successful bid. The U.S. courts seem to have settled in on break fees in the range if 1-2 per cent as being reasonable.[6]

Courts in the U.S. have examined break-fee arrangements with the concern that excessive break fees would chill the market and deter other potential bidders; however, commentators also suggest that break fees are necessary to attract a first bidder and get the auction process going. Generally, three lines of analysis have been used by courts to determine the appropriateness of the break fee.

First, in some situations courts have relied on the business-judgment rule and left to the seller's discretion the appropriateness of the existence of and/or amount of a break fee.

Second, courts in some situations have taken a harder look and applied a more thorough best interests of the estate test. For example in *Re Hupp Industries*[7] the court stated that the business-judgment rule was not appropriate in the insolvency context with respect to break fees because of the potentially detrimental effect that the allowance of such a fee would have on the debtor's estate. The court suggested the following factors be examined before approval of a break fee:

1. whether the fee requested co-relates with a maximization of value to the debtor's estate;
2. whether the request is arm's-length;
3. whether the principal stakeholders are supportive;
4. whether the break-up fee constitutes a fair and reasonable percentage of the proposed purchase price;
5. whether the dollar amount of the break-up fee would have a "chilling effect" on the market;
6. the existence of available safeguards; and
7. whether there exists a substantial adverse impact upon unsecured creditors where such creditors are in opposition.

6 See Paul B. Lackey, *An Empirical Survey and Proposed Bankruptcy Code Section Concerning the Property of Bidding Incentives in a Bankruptcy Sale of Assets*, 93 Column L. Rev. 720.

7 *Re Hupp Industries*, 140 B.R. 191 (Bank N.D. Ohio 1992).

Third, some U.S. case law has indicated that break fees should only be allowed to the extent that they compensate the stalking-horse bidder for the administrative expense associated with such role.

In an insolvency context, as explained below, a break fee may be the price of stability, and thus some premium over simply providing for administrative expense may be expected. The seven factors outlined in the *Re Hupp Industries* approach, above, appear to provide the parties negotiating the transaction, and a court reviewing same, with a reasonable method of gauging the appropriateness of the break fee in the circumstances. As such, this line of analysis appears to be preferable to the other two, which are either too broad or too restricted.

As a general proposition, break fees are a burden on the balance of the auction, in that competing bidders essentially have to pay these fees in order to succeed. While this may be fair in a situation when such bidder was allowed to compete for stalking-horse status, it could be more problematic when this is not the case. This was a complaint lodged by one bidder in the *Stelco* case.

(b) Topping fees

Topping fees are closely related to break fees and typically provide that the stalking-horse bidder receive a certain percentage of the amount by which the successful bidder exceeds the stalking-horse bid. Generally, topping fees have been considered alongside break fees by the courts.[8]

(c) Overbid increment protections

In many auctions, the stalking-horse bid is considered the base bid, and additional bids are accepted only at certain additional increments. In other words, each bid must outbid the last by a certain dollar amount. The size of the overbid protection increment, however, may influence the auction process. U.S. case law has indicated that the courts should focus on whether the increments are reasonable in relation to the proposed transaction.[9]

(d) Rights of first refusal

It is possible that a stalking horse may be granted rights of first refusal to match what would otherwise be the winning bid in an auction that may follow its bid. Effectively, this allows the stalking-horse bidder to forgo any overbid

8 See Paul B. Lackey, *supra*, at note 6.
9 *Ibid.*

increment required by the specific auction process, thus giving it an advantage against competing bidders. American commentators have noted that there is little case law considering rights of first refusal granted to stalking-horse bidders, but it is difficult to see how such an advantage could be countenanced by a court.

2. Control Incentives

In contrast to the economic incentives described above, the control incentives outlined below are, for the most part, common to both stalking-horse and tender-sale processes. In Canada, however, control incentives have not been of great concern where insolvency sales were conducted by a court officer (i.e., a trustee or receiver) whose reputation and duties as a court officer mitigated against the use of control incentives to manipulate the bidding process. However, as more and more asset sales in insolvency proceedings are being conducted by the debtor's management team and only monitored by a court officer, other stakeholder concerns related to control incentives are increasing.

Control incentives deal with the integrity of the process itself. These factors are considered in relation to manipulation of the actual bidding process and/or tender process and often potential bidders may, if they suspect that the integrity of the process is flawed, forgo the bidding process and the cost associated therewith.

(a) Controlling and shaping the bid process (timelines)

A primary method of controlling a bid process is to influence timelines. The shorter the timeline, the less time other parties have to conduct due diligence, communicate with management, negotiate a deal, and, hence, submit an informed offer. As timelines are often driven off of the amount of funding available to the debtor company, they become especially subject to manipulation where the DIP lender is a potential bidder.

Along with timelines in a stalking-horse auction, the bid process itself can be materially influenced by the form of the stalking-horse bid where subsequent bids are required to conform to the format of the stalking-horse bid. This is especially true in combination sales/equity-raising processes.

Stalking-horse bidders may also have considerable control and influence over the auction process, not only through the economic incentives discussed above, but also in setting the timelines and determining who may be treated as a qualified bidder at the auction.

Given the amount of control and influence a stalking-horse bid has on the ensuing auction, it should be clear that the stalking-horse bid is a viable and binding agreement. In this respect, specific attention should be focused on the

conditionality of the bid. For example, where the bid contains conditions that are likely never to be fulfilled, the stalking-horse benefits of the bid become illusive. For instance, a stalking-horse bid from, or sponsored by, an existing stakeholder who has an economic interest in obtaining the highest price might be, or operate as, nothing more than a shill.

Consequently, fairness and completeness in the competition to become the stalking-horse bid is, in many respects, just as important as it is in the final bid-approval process.

(b) Management incentives

Bids that contain various management incentives — whether they take the form of key employee retention packages, bonuses, or otherwise — have the effect of, at the very least, appearing to skew the bidding process. In a stalking-horse bid, these payments must be approved by the court prior to the auction and, thus, some level of control exists. However, in the race to become a stalking-horse bidder (a role that we have seen provides substantial influence over the sale process) management incentives may play a large role.

As well, in a tender process where the form of bids may vary substantially from one bid to another, thus making direct comparisons more difficult, management incentives may sway the process at the final selection phase.

Further, in Canada it is becoming more common to run concurrent sale and equity-raising processes. Equity-raising scenarios are often viewed in a more favourable light by existing management, as a sale of the business will most often be accompanied by a change of control. Again, these concerns are highlighted where sale processes are run by existing management, rather than a court-appointed officer.

(c) No shop and window shop clauses

Commentary in the U.S. indicates that it is very rare to have stalking-horse bids that contain a no-shop clause, which provides that a company cannot look for, entertain, or negotiate with other bidders, or a modified window-shop clause, which provides that, although a company cannot solicit other bids, it can receive bids and respond to bids as well as provide information to and negotiate with other bidders. In the few situations where these terms have been approved, one commentator notes that it was only done after extensive marketing by the company prior to filing.[10]

Thought should be given to the appropriateness of these clauses within the Canadian context when the debtor comes to court with a pre-arranged

10 *Ibid.*

agreement (whether it be for DIP financing, a sale of its assets, or some other transaction). Clearly, this kind of lock-up should only be allowed where the court is satisfied that it is looking at the best and final offer.

V. THE ROLE OF STALKING-HORSE BIDS IN CANADA

1. To Date

Although Canada has historically used and, therefore, is comfortable with a tender process for selling assets in an insolvency context, thought should be given to using an auction process in certain situations.

Courts have given no reason to shy away from the auction process solely on the basis that tender is better. Courts have, in fact, given the signal that, as long as the process meets the principles as laid out in *Soundair*,[11] the process will be considered acceptable. In cases that require cross-border harmonization, the use of the stalking-horse/auction process is clearly appropriate and has been recognized as such. There are also, however, a lesser number of cases where courts have approved of the stalking-horse concept where there was no cross-border element, the most notable of which has been *Stelco*.

In the A. & B. Sound Ltd. (A&B Sound) restructuring under the CCAA, the court at first approved a pre-packaged agreement whereby one bidder, Sun Capital (Sun Cap), was given an exclusive period in which to negotiate with A&B Sound. That period was later extended, and the court approved an agreement of purchase and sale between Sun Cap and A&B Sound, which included a break fee and a further exclusivity period. However, at the request of another bidder, Seanix Technology Inc. (Seanix), Seanix was granted access to all information that Sun Cap had been provided upon execution of a confidentiality agreement by Seanix. In effect, the court treated the Sun Cap bid as a stalking horse and, ultimately, Seanix submitted a higher offer that was approved.

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11 See *Royal Bank v. Soundair Corp.* (1991), 7 C.B.R. (3d) 1 (Ont. C.A.), at para 16 where the Ontario Court of Appeal summarized the duties a court must perform when decided whether a receiver who has sold property acted appropriately:

I summarize those duties as follows:

1. It should consider whether the receiver has made a sufficient effort to get the best price and has not acted improvidently.

2. It should consider the interests of all parties.

3. It should consider the efficacy and integrity of the process by which offers are obtained.

4. It should consider whether there has been unfairness in the working out of the process.

As well, in *Re Stelco Inc.*,[12] the court explicitly approved an offer from Deutche Bank, one of Stelco's significant bond holders, as a stalking-horse bid. As explained further below, the court found itself confronted with a situation where the Deutche Bank offer had been put on the table as a stalking-horse bid to satisfy a concern by General Motors (GM) (one of Stelco's largest customers) about the certainty of Stelco emerging successfully from its CCAA proceeding. GM had notified Stelco that, unless it had a viable plan of exit from the CCAA and had reached certain labour-negotiation milestones, it would re-source its business by a stipulated time. In order to deal with this demand, the court approved a limited canvassing of existing stakeholders to see if a proposal could be found that would guarantee Stelco's emergence from the CCAA. This resulted in the Deutche Bank offer, as well as others. On the morning of the hearing to approve the Deutche Bank proposal as a stalking horse, GM notified Stelco that it had not met the labour-relations milestone and that it would be re-sourcing its business. However, Stelco proceeded with the approval of the Deutche Bank bid anyway, despite the fact that the underlying rationale had disappeared. The court approved the Deutche Bank bid as a stalking horse; however, the bid contained conditions that adverse stakeholders and one competing bidder argued could never be fulfilled.

Specifically, these conditions required that: (i) Stelco and its union enter into a binding collective agreement with respect to a facility where the collective agreement had expired and (ii) that Stelco continue to enjoy the benefit of a pension holiday that the government had previously permitted, such that it did not have to pay down the solvency deficiency in certain pension plans in the manner generally required of other companies in Ontario. The bids progressed. All were rejected and the stalking horse failed because, as predicted, the conditions (specifically those noted above) could not be met. Only once further facts come out following the conclusion of the Stelco CCAA proceeding will an accurate picture emerge as to the positive or negative impact of the stalking-horse bidding procedure.

As well, in *Re Tiger Brand Knitting Co.*,[13] the court approved a stalking-horse bid by Geetex and approved a "stay fee", which had been negotiated by the monitor and Geetex, whereby Geetex received approximately $500,000 to leave its bid open as a stalking hosre for a certain period of time.

2. Tomorrow

Building on the case law in Canada to date, it is suggested that stalking-horse bids do have a place in intra-Canadian insolvencies. We suggest that the court should develop a standard where upon the approval of an agreement

12 *Re: Stelco, supra*, at note 2.

13 *Tiger Brand Knitting Co., Re* (2005), 9 C.B.R. (5th) 315 (Ont. S.C.J.).

(whether a purchase agreement, DIP financing agreement, *etc.*), if concerns exist about the completeness or fairness of the process generally, the approval should only be given as a stalking-horse bid, and not as a final agreement. If this standard were in place, debtor companies would come to court with the knowledge that, unless they could show that the process leading to the agreement in question was fair and complete, then it would be subject to approval as a stalking horse only. This would provide an incentive to ensure a fair and complete process in order to avoid approval as a stalking horse only.

It is recognized that even if such a standard was adopted there would still be circumstances where the court would be faced with a dilemma where concerns may exist about the fairness or completeness of the marketing process, but, nevertheless, approval of the agreement as a stalking horse may not be viable. The hope is that this will be less frequent. An emphasis on establishing a fair process would, in the context of DIP financing or pre-packaged arrangements, lead to greater involvement of the incumbent trustee, receiver, or monitor at a pre-filing stage so that a court officer and neutral third party could make a report and/or recommendation to the court regarding the adequacy of the marketing process right at the commencement of proceedings when such arrangements are, after approval, functionally entrenched.

Specific situations where stalking-horse bids may be appropriate to counteract potential unfairness or incompleteness of a marketing process include:

(a) Tight timelines

Where the need for certainty that the debtor will emerge from protection is required within a short time frame, stalking-horse bids may be very useful. The certainty of the ability of a debtor to emerge from insolvency protection can be very important in gaining the company the stability it needs to continue operations and seek higher bids. In that situation, the economic incentives discussed above may be seen as a cost of this stability, and the stalking-horse-bid process should be considered as an alternative to the traditional tender process. This was professed to be the case in *Stelco*. However, as discussed, it is not clear that this was, in fact, the case. It is suggested that in the proper case, consideration should be given to the use of stalking-horse bids in circumstances where there is a need for stability within a very short time frame.

(b) Limited market exposure

Where the sales process (or the DIP financing process) has received limited market exposure (whether as a function of timeliness or otherwise) stalking-horse bids may be appropriate. This would allow the agreement to be

approved and the debtor to continue operations, while the market could continue to be canvassed for higher bidders. For example, the DIP approved in *Air Canada* arguably reflected an extremely limited market exposure. In approving the DIP, the court did so at the cost of a substantial preference in favour of the DIP lender. In response to arguments that the preference was not appropriate, the DIP lender's position was that other parties could supply the DIP and were free to do so. In essence, the DIP lender's argument was that, in effect, their DIP agreement should be seen as a stalking horse. However, since the terms of the DIP agreement contained "window shop" provisions, the stalking-horse nature of the DIP agreement had little practical effect.

(c) Pre-packaged plans

Where the debtor has come into the insolvency proceedings with an agreement with respect to which it intends to seek approval from the court, greater concern for the completeness and fairness of the marketing process exists, and the court should consider limiting its approval of the agreement so that it will function only as a stalking horse unless the court can be shown that the process was in fact fair and complete.

VI. INTERMIXING AUCTION AND TENDER

It may be that the standard proposed above would lead to an intermixing between the traditional tender processes and the auction process. In each situation, thought should be given to any prejudice that may result from an intermixing of the two processes in the specific circumstances.

Clearly, it would not be appropriate to make a tender bid into a stalking horse without the consent of the bidder or, at least, in situations when the bidder knew that this was possible if the court was not satisfied with the bidding procedure since, in such circumstances, as discussed above, the bidder gets the worst of both systems. If, however, the standard proposed above was widely acknowledged as the process that would be followed by the court, concerns about imposing a stalking-horse bid on an unsuspecting tender bidder would be mitigated.

The question then becomes, once a stalking-horse bid procedure has been adopted, which is traditionally part of an auction process, is it necessary from a fairness perspective to adopt the full auction process, or can the bidding process revert back to a tender? In other words, while it is clear that there is prejudice switching from tender to auction, is there prejudice inherent in switching from auction to tender?

Consider the following scenario: at a live auction, bids are being accepted. As the bidding progresses, however, the auctioneer (realizing the auction

will last only for five more minutes) closes the bidding and asks that bidders write down their highest bid (as long as it is higher than the last oral bid) on a piece of paper, submit it to him so that whichever bid is the highest (the last oral bid or a written submission) will succeed. There does not appear anything inherently prejudicial in this scenario. Admittedly, if the bidders were aware that at some point the auction would be changed into a tender, it might influence their willingness to make oral bids, but it is difficult to see that this would be a material impact.

In an insolvency process, there may also be merit in migrating from an auction process and the approval of a stalking-horse bid to a tender scenario, in that the scope of the tender bid may become more flexible, and this may encourage a wider range of bidders. On balance, there does not appear to be any prejudice inherent in mixing the two processes in this way.

VII. CONCLUSION

There may be a role for stalking-horse bids in essentially Canadian insolvency proceedings. Neither tender nor auction processes are immune from manipulation. Consideration should be given, however, to selecting the process that is less subject to manipulation in the circumstances.

The courts in Canada have indicated a willingness to approve agreements on a stalking-horse basis in certain situations. It is suggested that this practice has merit in purely intra-Canadian insolvency proceedings, particularly in order to deal with inadequacies in the manner in which agreements that require court approval have been reached. Where there has not been an adequate canvas of the market for any reason, including lack of time or attempted manipulation of the process, it is suggested that, as a matter of practice, the court should grant an approval of an arrangement subject to overbid and further marketing. As such, the approved arrangement, be it a sale, DIP financing, or other agreement, will function as a stalking horse.

TAB "10"

Case Name:

Canwest Publishing Inc. (Re)

**IN THE MATTER OF the Companies' Creditors Arrangement Act, R.S.C. 1985, C-36, as amended
AND IN THE MATTER OF a Proposed Plan of Compromise or Arrangement of Canwest Publishing Inc./Publications Canwest Inc., Canwest Books Inc. and Canwest (Canada) Inc.**

[2010] O.J. No. 188

2010 ONSC 222

Court File No. CV-10-8533-00CL

Ontario Superior Court of Justice
Commercial List

S.E. Pepall J.

January 18, 2010.

(66 paras.)

Bankruptcy and insolvency law -- Assignments and petitions into bankruptcy -- Voluntary assignments -- By corporations and partnerships -- Canwest Global Canadian newspaper entities' application for a Companies' Creditors Arrangement Act protection order allowed -- The order applied to the applicants' limited partnership -- The limited partnership was the applicants' administrative backbone, exposing it to the demands of creditors would make a successful restructuring impossible -- The applicants could treat certain suppliers as critical suppliers but they could not be paid without the Monitor's consent -- The proposed DIP facility, financial advisor charge, directors and officers charge and management incentive plan charges were approved -- Companies' Creditors Arrangement Act, s. 4, s. 5, s. 11.2(1), s. 11.2(4), s. 11.4, s. 11.52.

Bankruptcy and insolvency law -- Companies' Creditors Arrangement Act (CCAA) matters -- Application of Act -- Affiliated debtor companies -- Canwest Global Canadian newspaper entities' application for a Companies' Creditors Arrangement Act protection order allowed -- The order applied to the applicants' limited partnership -- The limited partnership was the applicants' administrative backbone, exposing it to the demands of creditors would make a successful

restructuring impossible -- The applicants could treat certain suppliers as critical suppliers but they could not be paid without the Monitor's consent -- The proposed DIP facility, financial advisor charge, directors and officers charge and management incentive plan charges were approved -- Companies' Creditors Arrangement Act, s. 4, s. 5, s. 11.2(1), s. 11.2(4), s. 11.4, s. 11.52.

The Canwest Global Canadian newspaper entities applied for an order for protection pursuant to the Companies' Creditors Arrangement Act (CCAA). The applicants also sought a stay of proceedings and to have the order extend to protect the Canwest Limited Partnership/Canwest SociÚtÚ en Commandite (the Limited Partnership). The applicants proposed to present the plan only to the secured creditors and sought approval of a $25 million DIP facility. The applicants asked they be authorized but not required to pay pre-filing amounts owing in arrears to critical suppliers, including newsprint and ink suppliers. The applicants sought a $3 administration charge, a $10 million charge in favour of the financial advisor and a $35 directors and officers charge. The applicants also sought a $3 million charge to secure obligations arising out of amendments to two key employees' employment agreements and a management incentive plan.

HELD: Application allowed. The applicants' chief place of business was Ontario, they qualified as debtor companies under the CCAA and they were affiliated companies with total claims against them that far exceeded $5 million. The Limited Partnership was the applicants' administrative backbone. Exposing the assets of the Limited Partnership to the demands of creditors would make a successful restructuring impossible. Debtors had the statutory authority to present a plan to a single class of creditors and it was appropriate in the circumstances. The DIP loan would enhance the prospects of a viable compromise or arrangement and would ensure the necessary stability. The applicants could treat certain suppliers as critical suppliers but they could not be paid without the Monitor's consent. The administration charge, financial advisor charge and directors and officers charge were granted as requested. The management incentive charge was granted as requested and a sealing order was made over the sensitive personal and compensation information, as it was an important commercial interest that should be protected.

Statutes, Regulations and Rules Cited:

Companies' Creditors Arrangement Act, R.S.C. 1985, c. c. 36, s. 4, s. 5, s. 11.2(1), s. 11.2(4), s. 11.4, s. 11.52, s. 11.7(2)

Counsel:

Lyndon Barnes, Alex Cobb and Duncan Ault, for the Applicant LP Entities.

Mario Forte, for the Special Committee of the Board of Directors.

Andrew Kent and Hilary Clarke, for the Administrative Agent of the Senior Secured Lenders' Syndicate.

Peter Griffin, for the Management Directors.

Robin B. Schwill and Natalie Renner, for the Ad Hoc Committee of 9.25% Senior Subordinated Noteholders.

David Byers and Maria Konyukhova, for the proposed Monitor, FTI Consulting Canada Inc.

REASONS FOR DECISION

S.E. PEPALL J.:--

Introduction

1 Canwest Global Communications Corp. ("Canwest Global") is a leading Canadian media company with interests in (i) newspaper publishing and digital media; and (ii) free-to-air television stations and subscription based specialty television channels. Canwest Global, the entities in its Canadian television business (excluding CW Investments Co. and its subsidiaries) and the National Post Company (which prior to October 30, 2009 owned and published the National Post) (collectively, the "CMI Entities"), obtained protection from their creditors in a *Companies' Creditors Arrangement Act*[1] ("CCAA") proceeding on October 6, 2009.[2] Now, the Canwest Global Canadian newspaper entities with the exception of National Post Inc. seek similar protection. Specifically, Canwest Publishing Inc./Publications Canwest Inc. ("CPI"), Canwest Books Inc. ("CBI"), and Canwest (Canada) Inc. ("CCI") apply for an order pursuant to the CCAA. They also seek to have the stay of proceedings and the other benefits of the order extend to Canwest Limited Partnership/Canwest Société en Commandite (the "Limited Partnership"). The Applicants and the Limited Partnership are referred to as the "LP Entities" throughout these reasons. The term "Canwest" will be used to refer to the Canwest enterprise as a whole. It includes the LP Entities and Canwest Global's other subsidiaries which are not applicants in this proceeding.

2 All appearing on this application supported the relief requested with the exception of the Ad Hoc Committee of 9.25% Senior Subordinated Noteholders. That Committee represents certain unsecured creditors whom I will discuss more fully later.

3 I granted the order requested with reasons to follow. These are my reasons.

4 I start with three observations. Firstly, Canwest Global, through its ownership interests in the LP Entities, is the largest publisher of daily English language newspapers in Canada. The LP Entities own and operate 12 daily newspapers across Canada. These newspapers are part of the Canadian heritage and landscape. The oldest, The Gazette, was established in Montreal in 1778. The others are the Vancouver Sun, The Province, the Ottawa Citizen, the Edmonton Journal, the

Calgary Herald, The Windsor Star, the Times Colonist, The Star Phoenix, the Leader-Post, the Nanaimo Daily News and the Alberni Valley Times. These newspapers have an estimated average weekly readership that exceeds 4 million. The LP Entities also publish 23 non-daily newspapers and own and operate a number of digital media and online operations. The community served by the LP Entities is huge. In addition, based on August 31, 2009 figures, the LP Entities employ approximately 5,300 employees in Canada with approximately 1,300 of those employees working in Ontario. The granting of the order requested is premised on an anticipated going concern sale of the newspaper business of the LP Entities. This serves not just the interests of the LP Entities and their stakeholders but the Canadian community at large.

5 Secondly, the order requested may contain some shortcomings; it may not be perfect. That said, insolvency proceedings typically involve what is feasible, not what is flawless.

6 Lastly, although the builders of this insolvent business are no doubt unhappy with its fate, gratitude is not misplaced by acknowledging their role in its construction.

Background Facts

(i) Financial Difficulties

7 The LP Entities generate the majority of their revenues through the sale of advertising. In the fiscal year ended August 31, 2009, approximately 72% of the LP Entities' consolidated revenue derived from advertising. The LP Entities have been seriously affected by the economic downturn in Canada and their consolidated advertising revenues declined substantially in the latter half of 2008 and in 2009. In addition, they experienced increases in certain of their operating costs.

8 On May 29, 2009 the Limited Partnership failed, for the first time, to make certain interest and principal reduction payments and related interest and cross currency swap payments totaling approximately $10 million in respect of its senior secured credit facilities. On the same day, the Limited Partnership announced that, as of May 31, 2009, it would be in breach of certain financial covenants set out in the credit agreement dated as of July 10, 2007 between its predecessor, Canwest Media Works Limited Partnership, The Bank of Nova Scotia as administrative agent, a syndicate of secured lenders ("the LP Secured Lenders"), and the predecessors of CCI, CPI and CBI as guarantors. The Limited Partnership also failed to make principal, interest and fee payments due pursuant to this credit agreement on June 21, June 22, July 21, July 22 and August 21, 2009.

9 The May 29, 2009, defaults under the senior secured credit facilities triggered defaults in respect of related foreign currency and interest rate swaps. The swap counterparties (the "Hedging Secured Creditors") demanded payment of $68.9 million. These unpaid amounts rank pari passu with amounts owing under the LP Secured Lenders' credit facilities.

10 On or around August 31, 2009, the Limited Partnership and certain of the LP Secured Lenders entered into a forbearance agreement in order to allow the LP Entities and the LP Secured Lenders

the opportunity to negotiate a pre-packaged restructuring or reorganization of the affairs of the LP Entities. On November 9, 2009, the forbearance agreement expired and since then, the LP Secured Lenders have been in a position to demand payment of approximately $953.4 million, the amount outstanding as at August 31, 2009. Nonetheless, they continued negotiations with the LP Entities. The culmination of this process is that the LP Entities are now seeking a stay of proceedings under the CCAA in order to provide them with the necessary "breathing space" to restructure and reorganize their businesses and to preserve their enterprise value for the ultimate benefit of their broader stakeholder community.

11 The Limited Partnership released its annual consolidated financial statements for the twelve months ended August 31, 2009 and 2008 on November 26, 2009. As at August 31, 2009, the Limited Partnership had total consolidated assets with a net book value of approximately $644.9 million. This included consolidated current assets of $182.7 million and consolidated non-current assets of approximately $462.2 million. As at that date, the Limited Partnership had total consolidated liabilities of approximately $1.719 billion (increased from $1.656 billion as at August 31, 2008). These liabilities consisted of consolidated current liabilities of $1.612 billion and consolidated non-current liabilities of $107 million.

12 The Limited Partnership had been experiencing deteriorating financial results over the past year. For the year ended August 31, 2009, the Limited Partnership's consolidated revenues decreased by $181.7 million or 15% to $1.021 billion as compared to $1.203 billion for the year ended August 31, 2008. For the year ended August 31, 2009, the Limited Partnership reported a consolidated net loss of $66 million compared to consolidated net earnings of $143.5 million for fiscal 2008.

(ii) Indebtedness under the Credit Facilities

13 The indebtedness under the credit facilities of the LP Entities consists of the following.

(a) The LP senior secured credit facilities are the subject matter of the July 10, 2007 credit agreement already mentioned. They are guaranteed by CCI, CPI and CBI. The security held by the LP Secured Lenders has been reviewed by the solicitors for the proposed Monitor, FTI Consulting Canada Inc. and considered to be valid and enforceable.[3] As at August 31, 2009, the amounts owing by the LP Entities totaled $953.4 million exclusive of interest.[4]

(b) The Limited Partnership is a party to the aforementioned foreign currency and interest rate swaps with the Hedging Secured Creditors. Defaults under the LP senior secured credit facilities have triggered defaults in respect of these swap arrangements. Demand for repayment of amounts totaling $68.9 million (exclusive of unpaid interest) has been made. These

obligations are secured.

(c) Pursuant to a senior subordinated credit agreement dated as of July 10, 2007, between the Limited Partnership, The Bank of Nova Scotia as administrative agent for a syndicate of lenders, and others, certain subordinated lenders agreed to provide the Limited Partnership with access to a term credit facility of up to $75 million. CCI, CPI, and CBI are guarantors. This facility is unsecured, guaranteed on an unsecured basis and currently fully drawn. On June 20, 2009, the Limited Partnership failed to make an interest payment resulting in an event of default under the credit agreement. In addition, the defaults under the senior secured credit facilities resulted in a default under this facility. The senior subordinated lenders are in a position to take steps to demand payment.

(d) Pursuant to a note indenture between the Limited Partnership, The Bank of New York Trust Company of Canada as trustee, and others, the Limited Partnership issued 9.5% per annum senior subordinated unsecured notes due 2015 in the aggregate principal amount of US $400 million. CPI and CBI are guarantors. The notes are unsecured and guaranteed on an unsecured basis. The noteholders are in a position to take steps to demand immediate payment of all amounts outstanding under the notes as a result of events of default.

14 The LP Entities use a centralized cash management system at the Bank of Nova Scotia which they propose to continue. Obligations owed pursuant to the existing cash management arrangements are secured (the "Cash Management Creditor").

(iii) LP Entities' Response to Financial Difficulties

15 The LP Entities took a number of steps to address their circumstances with a view to improving cash flow and strengthening their balance sheet. Nonetheless, they began to experience significant tightening of credit from critical suppliers and other trade creditors. The LP Entities' debt totals approximately $1.45 billion and they do not have the liquidity required to make payment in respect of this indebtedness. They are clearly insolvent.

16 The board of directors of Canwest Global struck a special committee of directors (the "Special Committee") with a mandate to explore and consider strategic alternatives. The Special Committee has appointed Thomas Strike, the President, Corporate Development & Strategy Implementation, as Recapitalization Officer and has retained Gary Colter of CRS Inc. as Restructuring Advisor for the LP Entities (the "CRA"). The President of CPI, Dennis Skulsky, will report directly to the Special Committee.

17 Given their problems, throughout the summer and fall of 2009, the LP Entities have participated in difficult and complex negotiations with their lenders and other stakeholders to obtain

forbearance and to work towards a consensual restructuring or recapitalization.

18 An ad hoc committee of the holders of the senior subordinated unsecured notes (the "Ad Hoc Committee") was formed in July, 2009 and retained Davies Ward Phillips & Vineberg as counsel. Among other things, the Limited Partnership agreed to pay the Committee's legal fees up to a maximum of $250,000. Representatives of the Limited Partnership and their advisors have had ongoing discussions with representatives of the Ad Hoc Committee and their counsel was granted access to certain confidential information following execution of a confidentiality agreement. The Ad Hoc Committee has also engaged a financial advisor who has been granted access to the LP Entities' virtual data room which contains confidential information regarding the business and affairs of the LP Entities. There is no evidence of any satisfactory proposal having been made by the noteholders. They have been in a position to demand payment since August, 2009, but they have not done so.

19 In the meantime and in order to permit the businesses of the LP Entities to continue to operate as going concerns and in an effort to preserve the greatest number of jobs and maximize value for the stakeholders of the LP Entities, the LP Entities have been engaged in negotiations with the LP Senior Lenders, the result of which is this CCAA application.

(iv) The Support Agreement, the Secured Creditors' Plan and the Solicitation Process

20 Since August 31, 2009, the LP Entities and the LP administrative agent for the LP Secured Lenders have worked together to negotiate terms for a consensual, prearranged restructuring, recapitalization or reorganization of the business and affairs of the LP Entities as a going concern. This is referred to by the parties as the Support Transaction.

21 As part of this Support Transaction, the LP Entities are seeking approval of a Support Agreement entered into by them and the administrative agent for the LP Secured Lenders. 48% of the LP Secured Lenders, the Hedging Secured Creditors, and the Cash Management Creditor (the "Secured Creditors") are party to the Support Agreement.

22 Three interrelated elements are contemplated by the Support Agreement and the Support Transaction: the credit acquisition, the Secured Creditors' plan (the "Plan"), and the sale and investor solicitation process which the parties refer to as SISP.

23 The Support Agreement contains various milestones with which the LP Entities are to comply and, subject to a successful bid arising from the solicitation process (an important caveat in my view), commits them to support a credit acquisition. The credit acquisition involves an acquisition by an entity capitalized by the Secured Creditors and described as AcquireCo. AcquireCo. would acquire substantially all of the assets of the LP Entities (including the shares in National Post Inc.) and assume certain of the liabilities of the LP Entities. It is contemplated that AcquireCo. would offer employment to all or substantially all of the employees of the LP Entities and would assume all of the LP Entities' existing pension plans and existing post-retirement and post-employment

benefit plans subject to a right by AcquireCo., acting commercially reasonably and after consultation with the operational management of the LP Entities, to exclude certain specified liabilities. The credit acquisition would be the subject matter of a Plan to be voted on by the Secured Creditors on or before January 31, 2010. There would only be one class. The Plan would only compromise the LP Entities' secured claims and would not affect or compromise any other claims against any of the LP Entities ("unaffected claims"). No holders of the unaffected claims would be entitled to vote on or receive any distributions of their claims. The Secured Creditors would exchange their outstanding secured claims against the LP Entities under the LP credit agreement and the swap obligations respectively for their *pro rata* shares of the debt and equity to be issued by AcquireCo. All of the LP Entities' obligations under the LP secured claims calculated as of the date of closing less $25 million would be deemed to be satisfied following the closing of the Acquisition Agreement. LP secured claims in the amount of $25 million would continue to be held by AcquireCo. and constitute an outstanding unsecured claim against the LP Entities.

24 The Support Agreement contemplates that the Financial Advisor, namely RBC Dominion Securities Inc., under the supervision of the Monitor, will conduct the solicitation process. Completion of the credit acquisition process is subject to a successful bid arising from the solicitation process. In general terms, the objective of the solicitation process is to obtain a better offer (with some limitations described below) than that reflected in the credit acquisition. If none is obtained in that process, the LP Entities intend for the credit acquisition to proceed assuming approval of the Plan. Court sanction would also be required.

25 In more detailed terms, Phase I of the solicitation process is expected to last approximately 7 weeks and qualified interested parties may submit non-binding proposals to the Financial Advisor on or before February 26, 2010. Thereafter, the Monitor will assess the proposals to determine whether there is a reasonable prospect of obtaining a Superior Offer. This is in essence a cash offer that is equal to or higher than that represented by the credit acquisition. If there is such a prospect, the Monitor will recommend that the process continue into Phase II. If there is no such prospect, the Monitor will then determine whether there is a Superior Alternative Offer, that is, an offer that is not a Superior Offer but which might nonetheless receive approval from the Secured Creditors. If so, to proceed into Phase II, the Superior Alternative Offer must be supported by Secured Creditors holding more than at least 33.3% of the secured claims. If it is not so supported, the process would be terminated and the LP Entities would then apply for court sanction of the Plan.

26 Phase II is expected to last approximately 7 weeks as well. This period allows for due diligence and the submission of final binding proposals. The Monitor will then conduct an assessment akin to the Phase 1 process with somewhat similar attendant outcomes if there are no Superior Offers and no acceptable Alternative Superior Offers. If there were a Superior Offer or an acceptable Alternative Superior Offer, an agreement would be negotiated and the requisite approvals sought.

27 The solicitation process is designed to allow the LP Entities to test the market. One concern is

that a Superior Offer that benefits the secured lenders might operate to preclude a Superior Alternative Offer that could provide a better result for the unsecured creditors. That said, the LP Entities are of the view that the solicitation process and the support transaction present the best opportunity for the businesses of the LP Entities to continue as going concerns, thereby preserving jobs as well as the economic and social benefits of their continued operation. At this stage, the alternative is a bankruptcy or liquidation which would result in significant detriment not only to the creditors and employees of the LP Entities but to the broader community that benefits from the continued operation of the LP Entities' business. I also take some comfort from the position of the Monitor which is best captured in an excerpt from its preliminary Report:

> The terms of the Support Agreement and SISP were the subject of lengthy and intense arm's length negotiations between the LP Entities and the LP Administrative Agent. The Proposed Monitor supports approval of the process contemplated therein and of the approval of those documents, but without in any way fettering the various powers and discretions of the Monitor.

28 It goes without saying that the Monitor, being a court appointed officer, may apply to the court for advice and directions and also owes reporting obligations to the court.

29 As to the objection of the Ad Hoc Committee, I make the following observations. Firstly, they represent unsecured subordinated debt. They have been in a position to take action since August, 2009. Furthermore, the LP Entities have provided up to $250,000 for them to retain legal counsel. Meanwhile, the LP Secured Lenders have been in a position to enforce their rights through a non-consensual court proceeding and have advised the LP Entities of their abilities in that regard in the event that the LP Entities did not move forward as contemplated by the Support Agreement. With the Support Agreement and the solicitation process, there is an enhanced likelihood of the continuation of going concern operations, the preservation of jobs and the maximization of value for stakeholders of the LP Entities. It seemed to me that in the face of these facts and given that the Support Agreement expired on January 8, 2010, adjourning the proceeding was not merited in the circumstances. The Committee did receive very short notice. Without being taken as encouraging or discouraging the use of the comeback clause in the order, I disagree with the submission of counsel to the Ad Hoc Committee to the effect that it is very difficult if not impossible to stop a process relying on that provision. That provision in the order is a meaningful one as is clear from the decision in *Muscletech Research & Development Inc.*[5]. On a come back motion, although the positions of parties who have relied bona fide on an Initial Order should not be prejudiced, the onus is on the applicants for an Initial Order to satisfy the court that the existing terms should be upheld.

<u>Proposed Monitor</u>

30 The Applicants propose that FTI Consulting Canada Inc. serve as the Monitor. It currently serves as the Monitor in the CMI Entities' CCAA proceeding. It is desirable for FTI to act; it is qualified to act; and it has consented to act. It has not served in any of the incompatible capacities

described in section 11.7(2) of the CCAA. The proposed Monitor has an enhanced role that is reflected in the order and which is acceptable.

Proposed Order

31 As mentioned, I granted the order requested. It is clear that the LP Entities need protection under the CCAA. The order requested will provide stability and enable the LP Entities to pursue their restructuring and preserve enterprise value for their stakeholders. Without the benefit of a stay, the LP Entities would be required to pay approximately $1.45 billion and would be unable to continue operating their businesses.

(a) Threshold Issues

32 The chief place of business of the Applicants is Ontario. They qualify as debtor companies under the CCAA. They are affiliated companies with total claims against them that far exceed $5 million. Demand for payment of the swap indebtedness has been made and the Applicants are in default under all of the other facilities outlined in these reasons. They do not have sufficient liquidity to satisfy their obligations. They are clearly insolvent.

(b) Limited Partnership

33 The Applicants seek to extend the stay of proceedings and the other relief requested to the Limited Partnership. The CCAA definition of a company does not include a partnership or a limited partnership but courts have exercised their inherent jurisdiction to extend the protections of an Initial CCAA Order to partnerships when it was just and convenient to do so. The relief has been held to be appropriate where the operations of the partnership are so intertwined with those of the debtor companies that irreparable harm would ensue if the requested stay were not granted: *Re Canwest Global Communications Corp*[6] and *Re Lehndorff General Partners Ltd*[7].

34 In this case, the Limited Partnership is the administrative backbone of the LP Entities and is integral to and intertwined with the Applicants' ongoing operations. It owns all shared information technology assets; it provides hosting services for all Canwest properties; it holds all software licences used by the LP Entities; it is party to many of the shared services agreements involving other Canwest entities; and employs approximately 390 full-time equivalent employees who work in Canwest's shared services area. The Applicants state that failure to extend the stay to the Limited Partnership would have a profoundly negative impact on the value of the Applicants, the Limited Partnership and the Canwest Global enterprise as a whole. In addition, exposing the assets of the Limited Partnership to the demands of creditors would make it impossible for the LP Entities to successfully restructure. I am persuaded that under these circumstances it is just and convenient to grant the request.

(c) Filing of the Secured Creditors' Plan

35 The LP Entities propose to present the Plan only to the Secured Creditors. Claims of unsecured creditors will not be addressed.

36 The CCAA seems to contemplate a single creditor-class plan. Sections 4 and 5 state:

> s. 4 Where a compromise or an arrangement is proposed between a debtor company and its unsecured creditors or any class of them, the court may, on the application in a summary way of the company or of any such creditor or of the trustee in bankruptcy or liquidator of the company, order a meeting of the creditors or class of creditors and, it the court so determines, of the shareholders of the company, to be summoned in such manner as the court directs.
>
> s. 5 Where a compromise or an arrangement is proposed between a debtor company and its secured creditors or any class of them, the court may, on the application in a summary way of the company or of any such creditor or of the trustee in bankruptcy or liquidator of the company, order a meeting of the creditors or class of creditors and, if the court so determines, of the shareholders of the company, to be summoned in such manner as the court directs.

37 Case law has interpreted these provisions as authorizing a single creditor-class plan. For instance, Blair J. (as he then was) stated in *Re Philip Services Corp.*[8] : " There is no doubt that a debtor is at liberty, under the terms of sections 4 and 5 of the CCAA, to make a proposal to secured creditors or to unsecured creditors or to both groups."[9] Similarly, in *Re Anvil Range Mining Corp.*[10], the Court of Appeal stated: "It may also be noted that s. 5 of the CCAA contemplates a plan which is a compromise between a debtor company and its secured creditors and that by the terms of s. 6 of the Act, applied to the facts of this case, the plan is binding only on the secured creditors and the company and not on the unsecured creditors."[11]

38 Based on the foregoing, it is clear that a debtor has the statutory authority to present a plan to a single class of creditors. In *Re Anvil Range Mining Corp.*, the issue was raised in the context of the plan's sanction by the court and a consideration of whether the plan was fair and reasonable as it eliminated the opportunity for unsecured creditors to realize anything. The basis of the argument was that the motions judge had erred in not requiring a more complete and in depth valuation of the company's assets relative to the claims of the secured creditors.

39 In this case, I am not being asked to sanction the Plan at this stage. Furthermore, the Monitor will supervise a vigorous and lengthy solicitation process to thoroughly canvass the market for alternative transactions. The solicitation should provide a good indication of market value. In addition, as counsel for the LP Entities observed, the noteholders and the LP Entities never had any forbearance agreement. The noteholders have been in a position to take action since last summer but chose not to do so. One would expect some action on their part if they themselves believed that they "were in the money". While the process is not perfect, it is subject to the supervision of the court and the Monitor is obliged to report on its results to the court.

40 In my view it is appropriate in the circumstances to authorize the LP Entities to file and present a Plan only to the Secured Creditors.

(d) DIP Financing

41 The Applicants seek approval of a DIP facility in the amount of $25 million which would be secured by a charge over all of the assets of the LP Entities and rank ahead of all other charges except the Administration Charge, and ahead of all other existing security interests except validly perfected purchase money security interests and certain specific statutory encumbrances.

42 Section 11.2 of the CCAA provides the statutory jurisdiction to grant a DIP charge. In *Re Canwest*[12], I addressed this provision. Firstly, an applicant should address the requirements contained in section 11.2 (1) and then address the enumerated factors found in section 11.2(4) of the CCAA. As that list is not exhaustive, it may be appropriate to consider other factors as well.

43 Applying these principles to this case and dealing firstly with section 11.2(1) of the CCAA, notice either has been given to secured creditors likely to be affected by the security or charge or alternatively they are not affected by the DIP charge. While funds are not anticipated to be immediately necessary, the cash flow statements project a good likelihood that the LP Entities will require the additional liquidity afforded by the $25 million. The ability to borrow funds that are secured by a charge will help retain the confidence of the LP Entities' trade creditors, employees and suppliers. It is expected that the DIP facility will permit the LP Entities to conduct the solicitation process and consummate a recapitalization transaction of a sale of all or some of its assets. The charge does not secure any amounts that were owing prior to the filing. As such, there has been compliance with the provisions of section 11.2 (1).

44 Turning then to a consideration of the factors found in section 11.2(4) of the Act, the LP Entities are expected to be subject to these CCAA proceedings until July 31, 2010. Their business and financial affairs will be amply managed during the proceedings. This is a consensual filing which is reflective of the confidence of the major creditors in the current management configuration. All of these factors favour the granting of the charge. The DIP loan would enhance the prospects of a viable compromise or arrangement and would ensure the necessary stability during the CCAA process. I have already touched upon the issue of value. That said, in relative terms, the quantum of the DIP financing is not large and there is no readily apparent material prejudice to any creditor arising from the granting of the charge and approval of the financing. I also note that it is endorsed by the proposed Monitor in its report.

45 Other factors to consider in assessing whether to approve a DIP charge include the reasonableness of the financing terms and more particularly the associated fees. Ideally there should be some evidence on this issue. Prior to entering into the forbearance agreement, the LP Entities sought proposals from other third party lenders for a DIP facility. In this case, some but not all of the Secured Creditors are participating in the financing of the DIP loan. Therefore, only some would benefit from the DIP while others could bear the burden of it. While they may have opted not to

participate in the DIP financing for various reasons, the concurrence of the non participating Secured Creditors is some market indicator of the appropriateness of the terms of the DIP financing.

46 Lastly, I note that the DIP lenders have indicated that they would not provide a DIP facility if the charge was not approved. In all of these circumstances, I was prepared to approve the DIP facility and grant the DIP charge.

(e) Critical Suppliers

47 The LP Entities ask that they be authorized but not required to pay pre-filing amounts owing in arrears to certain suppliers if the supplier is critical to the business and ongoing operations of the LP Entities or the potential future benefit of the payments is considerable and of value to the LP Entities as a whole. Such payments could only be made with the consent of the proposed Monitor. At present, it is contemplated that such suppliers would consist of certain newspaper suppliers, newspaper distributors, logistic suppliers and the Amex Bank of Canada. The LP Entities do not seek a charge to secure payments to any of its critical suppliers.

48 Section 11.4 of the CCAA addresses critical suppliers. It states:

> 11.4(1) On application by a debtor company and on notice to the secured creditors who are likely to be affected by the security or charge, the court may make an order declaring a person to be a critical supplier to the company if the court is satisfied that the person is a supplier of goods and services to the company and that the goods or services that are supplied are critical to the company's continued operation.
>
> (2) If the court declares the person to be a critical supplier, the court may make an order requiring the person to supply any goods or services specified by the court to the company on any terms and conditions that are consistent with the supply relationship or that the court considers appropriate.
>
> (3) If the court makes an order under subsection (2), the court shall, in the order, declare that all or part of the property of the company is subject to a security or charge in favour of the person declared to be a critical supplier, in an amount equal to the value of the goods or services supplied upon the terms of the order.
>
> (4) The court may order that the security or charge rank in priority over the claim of any secured creditor of the company.

49 Mr. Byers, who is counsel for the Monitor, submits that the court has always had discretion to authorize the payment of critical suppliers and that section 11.4 is not intended to address that issue. Rather, it is intended to respond to a post-filing situation where a debtor company wishes to compel a supplier to supply. In those circumstances, the court may declare a person to be a critical supplier and require the person to supply. If the court chooses to compel a person to supply, it must

authorize a charge as security for the supplier. Mr. Barnes, who is counsel for the LP Entities, submits that section 11.4 is not so limited. Section 11.4 (1) gives the court general jurisdiction to declare a supplier to be a "critical supplier" where the supplier provides goods or services that are essential to the ongoing business of the debtor company. The permissive as opposed to mandatory language of section 11.4 (2) supports this interpretation.

50 Section 11.4 is not very clear. As a matter of principle, one would expect the purpose of section 11.4 to be twofold: (i) to codify the authority to permit suppliers who are critical to the continued operation of the company to be paid and (ii) to require the granting of a charge in circumstances where the court is compelling a person to supply. If no charge is proposed to be granted, there is no need to give notice to the secured creditors. I am not certain that the distinction between Mr. Byers and Mr. Barnes' interpretation is of any real significance for the purposes of this case. Either section 11.4(1) does not oust the court's inherent jurisdiction to make provision for the payment of critical suppliers where no charge is requested or it provides authority to the court to declare persons to be critical suppliers. Section 11.4(1) requires the person to be a supplier of goods and services that are critical to the companies' operation but does not impose any additional conditions or limitations.

51 The LP Entities do not seek a charge but ask that they be authorized but not required to make payments for the pre-filing provision of goods and services to certain third parties who are critical and integral to their businesses. This includes newsprint and ink suppliers. The LP Entities are dependent upon a continuous and uninterrupted supply of newsprint and ink and they have insufficient inventory on hand to meet their needs. It also includes newspaper distributors who are required to distribute the newspapers of the LP Entities; American Express whose corporate card programme and accounts are used by LP Entities employees for business related expenses; and royalty fees accrued and owing to content providers for the subscription-based on-line service provided by FPinfomart.ca, one of the businesses of the LP Entities. The LP Entities believe that it would be damaging to both their ongoing operations and their ability to restructure if they are unable to pay their critical suppliers. I am satisfied that the LP Entities may treat these parties and those described in Mr. Strike's affidavit as critical suppliers but none will be paid without the consent of the Monitor.

(f) Administration Charge and Financial Advisor Charge

52 The Applicants also seek a charge in the amount of $3 million to secure the fees of the Monitor, its counsel, the LP Entities' counsel, the Special Committee's financial advisor and counsel to the Special Committee, the CRA and counsel to the CRA. These are professionals whose services are critical to the successful restructuring of the LP Entities' business. This charge is to rank in priority to all other security interests in the LP Entities' assets, with the exception of purchase money security interests and specific statutory encumbrances as provided for in the proposed order.[13] The LP Entities also request a $10 million charge in favour of the Financial Advisor, RBC Dominion Securities Inc. The Financial Advisor is providing investment banking services to the LP

Entities and is essential to the solicitation process. This charge would rank in third place, subsequent to the administration charge and the DIP charge.

53 In the past, an administration charge was granted pursuant to the inherent jurisdiction of the court. Section 11.52 of the amended CCAA now provides statutory jurisdiction to grant an administration charge. Section 11.52 states:

> On notice to the secured creditors who are likely to be affected by the security or charge, the court may make an order declaring that all or part of the property of the debtor company is subject to a security or charge - in an amount that the court considers appropriate - in respect of the fees and expenses of
>
> (a) the monitor, including the fees and expenses of any financial, legal or other experts engaged by the monitor in the performance of the monitor's duties;
> (b) any financial, legal or other experts engaged by the company for the purpose of proceedings under this Act; and
> (c) any financial, legal or other experts engaged by any other interested person if the court is satisfied that the security or charge is necessary for their effective participation in proceedings under this Act.
> (2) The court may order that the security or charge rank in priority over the claim of any secured creditor of the company.

54 I am satisfied that the issue of notice has been appropriately addressed by the LP Entities. As to whether the amounts are appropriate and whether the charges should extend to the proposed beneficiaries, the section does not contain any specific criteria for a court to consider in its assessment. It seems to me that factors that might be considered would include:

(a) the size and complexity of the businesses being restructured;
(b) the proposed role of the beneficiaries of the charge;
(c) whether there is an unwarranted duplication of roles;
(d) whether the quantum of the proposed charge appears to be fair and reasonable;
(e) the position of the secured creditors likely to be affected by the charge; and
(f) the position of the Monitor.

This is not an exhaustive list and no doubt other relevant factors will be developed in the jurisprudence.

55 There is no question that the restructuring of the LP Entities is large and highly complex and it is reasonable to expect extensive involvement by professional advisors. Each of the professionals whose fees are to be secured has played a critical role in the LP Entities restructuring activities to date and each will continue to be integral to the solicitation and restructuring process. Furthermore,

there is no unwarranted duplication of roles. As to quantum of both proposed charges, I accept the Applicants' submissions that the business of the LP Entities and the tasks associated with their restructuring are of a magnitude and complexity that justify the amounts. I also take some comfort from the fact that the administrative agent for the LP Secured Lenders has agreed to them. In addition, the Monitor supports the charges requested. The quantum of the administration charge appears to be fair and reasonable. As to the quantum of the charge in favour of the Financial Advisor, it is more unusual as it involves an incentive payment but I note that the Monitor conducted its own due diligence and, as mentioned, is supportive of the request. The quantum reflects an appropriate incentive to secure a desirable alternative offer. Based on all of these factors, I concluded that the two charges should be approved.

(g) Directors and Officers

56 The Applicants also seek a directors and officers charge ("D & O charge") in the amount of $35 million as security for their indemnification obligations for liabilities imposed upon the Applicants' directors and officers. The D & O charge will rank after the Financial Advisor charge and will rank pari passu with the MIP charge discussed subsequently. Section 11.51 of the CCAA addresses a D & O charge. I have already discussed section 11.51 in *Re Canwest*[14] as it related to the request by the CMI Entities for a D & O charge. Firstly, the charge is essential to the successful restructuring of the LP Entities. The continued participation of the experienced Boards of Directors, management and employees of the LP Entities is critical to the restructuring. Retaining the current officers and directors will also avoid destabilization. Furthermore, a CCAA restructuring creates new risks and potential liabilities for the directors and officers. The amount of the charge appears to be appropriate in light of the obligations and liabilities that may be incurred by the directors and officers. The charge will not cover all of the directors' and officers' liabilities in a worse case scenario. While Canwest Global maintains D & O liability insurance, it has only been extended to February 28, 2009 and further extensions are unavailable. As of the date of the Initial Order, Canwest Global had been unable to obtain additional or replacement insurance coverage.

57 Understandably in my view, the directors have indicated that due to the potential for significant personal liability, they cannot continue their service and involvement in the restructuring absent a D & O charge. The charge also provides assurances to the employees of the LP Entities that obligations for accrued wages and termination and severance pay will be satisfied. All secured creditors have either been given notice or are unaffected by the D & O charge. Lastly, the Monitor supports the charge and I was satisfied that the charge should be granted as requested.

(h) Management Incentive Plan and Special Arrangements

58 The LP Entities have made amendments to employment agreements with 2 key employees and have developed certain Management Incentive Plans for 24 participants (collectively the "MIPs"). They seek a charge in the amount of $3 million to secure these obligations. It would be subsequent to the D & O charge.

59 The CCAA is silent on charges in support of Key Employee Retention Plans ("KERPs") but they have been approved in numerous CCAA proceedings. Most recently, in *Re Canwest*[15], I approved the KERP requested on the basis of the factors enumerated in *Re Grant Forrest*[16] and given that the Monitor had carefully reviewed the charge and was supportive of the request as were the Board of Directors, the Special Committee of the Board of Directors, the Human Resources Committee of Canwest Global and the Adhoc Committee of Noteholders.

60 The MIPs in this case are designed to facilitate and encourage the continued participation of certain senior executives and other key employees who are required to guide the LP Entities through a successful restructuring. The participants are critical to the successful restructuring of the LP Entities. They are experienced executives and have played critical roles in the restructuring initiatives to date. They are integral to the continued operation of the business during the restructuring and the successful completion of a plan of restructuring, reorganization, compromise or arrangement.

61 In addition, it is probable that they would consider other employment opportunities in the absence of a charge securing their payments. The departure of senior management would distract from and undermine the restructuring process that is underway and it would be extremely difficult to find replacements for these employees. The MIPs provide appropriate incentives for the participants to remain in their current positions and ensures that they are properly compensated for their assistance in the reorganization process.

62 In this case, the MIPs and the MIP charge have been approved in form and substance by the Board of Directors and the Special Committee of Canwest Global. The proposed Monitor has also expressed its support for the MIPs and the MIP charge in its pre-filing report. In my view, the charge should be granted as requested.

(i) Confidential Information

63 The LP Entities request that the court seal the confidential supplement which contains individually identifiable information and compensation information including sensitive salary information about the individuals who are covered by the MIPs. It also contains an unredacted copy of the Financial Advisor's agreement. I have discretion pursuant to Section 137(2) of the *Courts of Justice Act*[17] to order that any document filed in a civil proceeding be treated as confidential, sealed and not form part of the public record. That said, public access in an important tenet of our system of justice.

64 The threshold test for sealing orders is found in the Supreme Court of Canada decision of *Sierra Club of Canada v Canada (Minister of Finance)*[18]. In that case, Iacobucci J. stated that an order should only be granted when: (i) it is necessary in order to prevent a serious risk to an important interest, including a commercial interest, in the context of litigation because reasonable alternative measures will not prevent the risk; and (ii) the salutary effects of the confidentiality order, including the effects on the right of civil litigants to a fair trial, outweigh its deleterious

effects, including the effects on the right to free expression, which in this context includes the public interest in open and accessible court proceedings.

65 In *Re Canwest*[19] I applied the *Sierra Club* test and approved a similar request by the Applicants for the sealing of a confidential supplement containing unredacted copies of KERPs for the employees of the CMI Entities. Here, with respect to the first branch of the *Sierra Club* test, the confidential supplement contains unredacted copies of the MIPs. Protecting the disclosure of sensitive personal and compensation information of this nature, the disclosure of which would cause harm to both the LP Entities and the MIP participants, is an important commercial interest that should be protected. The information would be of obvious strategic advantage to competitors. Moreover, there are legitimate personal privacy concerns in issue. The MIP participants have a reasonable expectation that their names and their salary information will be kept confidential. With respect to the second branch of the *Sierra Club* test, keeping the information confidential will not have any deleterious effects. As in the *Re Canwest* case, the aggregate amount of the MIP charge has been disclosed and the individual personal information adds nothing. The salutary effects of sealing the confidential supplement outweigh any conceivable deleterious effects. In the normal course, outside of the context of a CCAA proceeding, confidential personal and salary information would be kept confidential by an employer and would not find its way into the public domain. With respect to the unredacted Financial Advisor agreement, it contains commercially sensitive information the disclosure of which could be harmful to the solicitation process and the salutary effects of sealing it outweigh any deleterious effects. The confidential supplements should be sealed and not form part of the public record at least at this stage of the proceedings.

Conclusion

66 For all of these reasons, I was prepared to grant the order requested.

S.E. PEPALL J.

cp/e/qlafr/qljxr/qlltl/qljyw/qlaxw

1 R.S.C. 1985, c. C. 36, as amended.

2 On October 30, 2009, substantially all of the assets and business of the National Post Company were transferred to the company now known as National Post Inc.

3 Subject to certain assumptions and qualifications.

4 Although not formally in evidence before the court, counsel for the LP Secured Lenders

advised the court that currently $382,889,000 in principal in Canadian dollars is outstanding along with $458,042,000 in principal in American dollars.

5 2006 CarswellOnt 264 (S.C.J.).

6 [2009] O.J. No. 4286, 2009 CarswellOnt 6184 at para. 29 (S.C.J.).

7 (1993), 9 B.L.R. (2d) 275 (Ont. Gen. Div.).

8 [1999] O.J. No. 4232, 1999 CarswellOnt 4673 (S.C.J.).

9 Ibid at para. 16.

10 (2002),34 C.B.R. (4th) 157 (Ont. C.A.), leave to appeal to S.C.C., [2002] S.C.C.A. No. 389, refused (March 6, 2003).

11 Ibid at para. 34.

12 Supra, note 7 at paras. 31-35.

13 This exception also applies to the other charges granted.

14 Supra note 7 at paras. 44-48.

15 Supra note 7.

16 [2009] O.J. No. 3344 (S.C.J.).

17 R.S.O. 1990, c. C.43, as amended.

18 [2002] 2 S.C.R. 522.

19 Supra, note 7 at para. 52.

TAB "11"

Case Name:

River Rentals Group Ltd. v. Hutterian Brethren Church of Codesa

Between
Bank of Montreal, Not a Party To the Appeal, (Plaintiff), and
River Rentals Group Ltd., Taves Contractors Ltd. and McTaves Inc., Respondent, (Defendant), and
Hutterian Brethren Church of Codesa, Appellant, (Other), and
Bill McCulloch and Associates Inc., Respondent, (Other), and
Don Warkentin, Respondent, (Other)

[2010] A.J. No. 12

2010 ABCA 16

469 A.R. 333

18 Alta. L.R. (5th) 201

2010 CarswellAlta 57

Dockets: 0903-0191-AC, 0903-0236-AC

Registry: Edmonton

Alberta Court of Appeal
Edmonton, Alberta

R.L. Berger and P.A. Rowbotham JJ.A. and R.P. Belzil J. (ad hoc),

Heard: January 7, 2010.
Judgment: January 18, 2010.

(22 paras.)

Bankruptcy and insolvency law -- Administration of estate -- Sale of property -- Administrative officials and appointees -- Duties and powers -- Sale of assets -- Approval -- Appeal by highest

bidder in tender to purchase property from receiver, from order extending tender process -- Appeal allowed -- Another bidder had convinced court he misunderstood date on which he was to obtain possession of property, and therefore made lower bid than he would have otherwise -- In extending process, court gave other bidder benefit of knowing what high bid was without justification, and failed to consider interests of high bidder and other participants in process.

Real property law -- Sale of land -- Tender -- Appeal by highest bidder in tender to purchase property from receiver, from order extending tender process -- Appeal allowed -- Another bidder had convinced court he misunderstood date on which he was to obtain possession of property, and therefore made lower bid than he would have otherwise -- In extending process, court gave other bidder benefit of knowing what high bid was without justification, and failed to consider interests of high bidder and other participants in process.

Appeal by the Hutterian Bretheren Church from an order extending the tendering process to purchase certain property from the receiver of a bankrupt. The receiver of the bankrupt had issued a call for offers to purchase the property. The Church made the highest offer at $2.2 million. The Receiver applied to have the Church's offer approved. Warkentin had also submitted a bid in the process. He argued it later became clear that he would be able to obtain possession of the property earlier than he had anticipated at the time he made his bid, and that, had he known this, he would have made a bid higher than that of the Church. The judge approved a re-tendering based on Warkentin's misunderstanding of the dates of occupation. Warkentin submitted a bid higher than the Church's bid in the new tendering process.

HELD: Appeal allowed. The order was set aside and the bid of the Church was approved. Ordering a re-tendering effectively conveyed to Warkentin an advantage in that he knew what the Church was offering and was able to better it. There was no evidence of any unfairness to Warkentin in the initial tendering process. The judge erred in failing to consider the interests of the Church as the highest bidder in the initial tendering process, or the interests of the other bidders.

Appeal From:

Appeal from the Orders by The Honourable Chief Justice A.H. Wachowich. Dated the 2nd day of June, 2009 and dated the 17th day of June, 2009 (Docket: 0903 03233).

Counsel:

D.R. Bieganek, for the Respondent - River Rentals Group, Taves Contractors Ltd. and McTaves Inc., for the Respondent - Bill McCulloch and Associates Inc.

G.D. Chrenek, for the Appellant - Hutterian Brethren Church of Codesa.

T.M. Warner, for the Respondent - Don Warkentin.

Memorandum of Judgment

The following judgment was delivered by

1 THE COURT:-- At the hearing of this appeal, we announced that the appeal is allowed with reasons to follow.

2 Bill McCulloch and Associates Inc. is the court-appointed Interim Receiver and/or Receiver Manager of the corporate Respondents ("the Taves Group") by order dated March 5, 2009. Prior to that date, the Receiver had become Trustee in Bankruptcy of the Taves Group.

3 The Receiver issued an information package and called for offers to purchase the assets of the Taves Group which included a property known as the Birch Hills Lands. The call for offers was dated April 17, 2009. The deadline for submission of offers was on or before May 7, 2009 (the tender closing date).

4 On June 2, 2009, the Receiver brought an application before Wachowich C.J.Q.B. to approve the sale of the Birch Hills Lands to the Appellant. The Appellant's offer was $2,205,000. An appraisal concluded that the most probable sale price was $1,560,000. Counsel for the Receiver explained that "the Receiver did effect wide advertizing in local and national newspapers. Sent out 160 tender packages and made the tender package available on the Receiver's website." (A.B. Record Digest, 3/30-33)

5 Fifteen offers were received on the Birch Hills Lands, six of which were for the entirety of the parcel.

6 In his submission to the Chief Justice, counsel for the Receiver stated:

> "Now, what we have advised the party that we're looking to accept is that we can't put them in possession yet until the Court approves the offer. That has caused some angst given the time of year and it is agricultural land, but we're not in a position to put people on the land before we get court approval to do so. So - - and that's fine, they're still - - they're still at the table so we're good with that.
>
> The offer that the Receiver is recommending acceptance of is - - was from the Hutterite Church of Codesa. That offer was for $2,205,000 ... the offer is very significant ... it was an excellent offer."

(A.B. Record Digest, 5/46 -6/19)

7 In considering other tenders with respect to other portions of the property of the Taves Group, the Chief Justice expressed his views regarding the importance of adhering to the integrity of the tender process:

> "You know, we ran a tender process, tender process is meant to be - - there are certain rules. It is like, you do not change the rules of baseball or football during the middle of the game. This is the same thing except in this particular case the Court is prepared to exercise the - - its inherent jurisdiction to extend the time in Mr. Taves' position. But I - - you know, I could be the person who says no, Mr. Taves, you were late, I am sorry. Next time use Fed Ex."
>
> (Appeal Record Digest, 12/11-19)

And further:

> "We could be coming back right and left. I am inclined, you know, to grant the applications as submitted on these tenders because the tender process was followed properly. That was the market at the time, this is the people that - - this is how they bid. You know, circumstances change and when circumstances change, somebody is the beneficiary of it, some - - somebody is the loser on this. But the rules were adhered to and having the rules adhered to if, you know - - if you want to - - if you want to go to the Court of Appeal after the order is entered and say to the Court of Appeal, guess what, oil is now at $90, we want this one resubmitted. And if those five people are wise enough to accept that argument, then good luck to you but - - but you know, I am inclined to say we follow a process, the law has to be certain. The law has to be definite. This is what we did and we complied." (Appeal Record Digest, 12/40-13/8)

8 One of the persons who had tendered an offer to purchase the Birch Hills Lands was the Respondent Don Warkentin. Counsel for the guarantor, Mr. Orrin Toews, addressed the Court. He explained that Mr. Warkentin had submitted an offer of $2.1 million "on the understanding that he would be receiving possession of the property sometime in the fall." Counsel further explained that "I believe it was the Receiver while during the initial auction, that it was brought to his attention on May 21st that he would in fact get possession of the property much earlier than he was anticipating. And on that basis he increased his bid by 200,000 which brings his offer to 2.3 million dollars cash." (A.B. Record Digest, 13/27-36) He submitted that Mr. Warkentin's offer be accepted.

9 In response, counsel for the Receiver advised the Court that he had been in written

communication with counsel for Mr. Warkentin "and there was no indication in that correspondence that he thought he would get [possession of the lands] in the fall." (Appeal Record Digest, 14/18-20) He added: "I think the tender package is clear that the way it was supposed to close is after the appeal periods on any order has expired. ... So how anybody could reasonably conceive that possession wouldn't be granted until the fall based on that escapes me." (Appeal Record Digest, 14/20-25) He further added: "But the bottom line was at the time tenders closed, Mr. [Warkentin]'s offer was found wanting." (Appeal Record Digest, 14/36-38)

10 On the basis of that information, the Court ruled as follows:

> "Well, you know, rather than adjourning it to hear from Mr. Carter, what I am - - what I am inclined to do with that piece of property, because of - - is - - because of an uncertainty as to occupation, dates of occupation or potential lease or whatever it may be, it is too late to put in the crop right now anyway so - - ... Retender on this one and make it clear in the tender." (Appeal Record Digest, 15/7-19)

11 Wachowich, C.J. then granted an order extending the deadline to submit revised offers to purchase the Birch Hills Lands; with submissions restricted to the Appellant and Warkentin. During this extension period, Warkentin submitted a bid higher than the Appellant's. The Appellant did not increase its original offer. Subsequently, on June 17, 2009, Wachowich, C.J. granted an order directing that the Birch Hills Lands be sold to Warkentin. An application by the Appellant to reconsider the June 17, 2009 order was dismissed. The Court also granted a stay order for parts of the June 2 order and the entirety of its June 17 order, pending the determination of the appeal of the June 2 order. The Appellant appealed the June 2 order on July 22, 2009; and appealed the June 17 order on August 13, 2009 (the appeals were consolidated on August 20, 2009).

12 On applications by a Receiver for approval of a sale, the Court should consider whether the Receiver has acted properly. Specifically, the Court should consider the following:

> (a) whether the Receiver has made a sufficient effort to get the best price and has not acted improvidently;
> (b) the interests of all parties;
> (c) the efficacy and integrity of the process by which offers are obtained; and
> (d) whether there has been unfairness in the working out of the process.
>
> ***Royal Bank of Canada v. Soundair Corp.***, (1991), 4 O.R. (3d) 1 (C.A.), at para. 16

13 The Court should consider the following factors to determine if the Receiver has acted improvidently or failed to get the best price:

(a) whether the offer accepted is so low in relation to the appraised value as to be unrealistic;
(b) whether the circumstances indicate that insufficient time was allowed for the making of bids;
(c) whether inadequate notice of sale by bid was given; or
(d) whether it can be said that the proposed sale is not in the best interest of either the creditors or the owner.

Cameron v. Bank of Nova Scotia (1981), 45 N.S.R. (2d) 303 (C.A.)

Salima Investments Ltd. v. Bank of Montreal (1985), 65 A.R. 372 (C.A.) at para. 12.

14 The central issue in this appeal is whether the chambers judge, mindful of the record before him, should have permitted rebidding and whether he should have thereafter entertained and accepted the higher offer of $2.51 million plus GST tendered by Mr. Warkentin during the extension period.

15 The relevance of higher offers after the close of process was considered by the Ontario Court of Appeal in ***Royal Bank v. Soundair, supra***. Upon review of the jurisprudence, the Court stated at para. 30:

> "What those cases show is that the prices in other offers have relevance only if they show that the price contained in the offer accepted by the receiver was so unreasonably low as to demonstrate that the receiver was improvident in accepting it. ..."

16 The chambers judge made no such finding. Indeed, he made no assessment whatever of the conduct of the Receiver. The only evidence before the Court at the June 2, 2009 application was the Receiver's fifth report and the affidavit of Orrin Toews who proffered no evidence that the Receiver acted improvidently in accepting the offer of the Appellant.

17 Moreover, the June 2, 2009 order neither considers the interests of the Appellant as the highest bidder nor the interests of others who made compliant, but unsuccessful, bids to purchase the Birch Hills Lands pursuant to the call for offers.

18 This Court has consistently favoured an approach that preserves the integrity of the process. See ***Salima Investments Ltd., supra***, and ***Royal Bank of Canada v. Fracmaster Ltd.***, 1999 ABCA 178, 244 A.R. 93.

19 That was also the view of the Nova Scotia Supreme Court (Appeal Division) in ***Cameron v.***

Bank of Nova Scotia, supra, at para. 35:

> "In my opinion if the decision of the receiver to enter into an agreement of sale, subject to court approval, with respect to certain assets is reasonable and sound under the circumstances at the time existing it should not be set aside simply because a later and a higher bid is made. To do so would literally create chaos in the commercial world and receivers and purchasers would never be sure they had a binding agreement. On the contrary, they would know that other bids could be received and considered up until the application for court approval is heard - this would be an intolerable situation. ..."

20 In addition, there was no cogent evidence before the chambers judge of any unfairness to Warkentin. On the contrary, the impugned order of June 2 conferred an advantage upon Warkentin who then knew the price that had previously been offered by the Appellant when re-tendering his offer.

21 In cases involving the Court's consideration of the approval of the sale of assets by a court-appointed Receiver, decisions made by a chambers judge involve a measure of discretion and "are owed considerable deference". The Court will interfere only if it concludes that the chambers judge acted unreasonably, erred in principle, or made a manifest error.

22 In our opinion, the chambers judge erred in principle and on insufficient evidence ordered that the property in question be the subject of an extended re-tendering process. The appeal is allowed. An order will go setting aside paras. 26 through 32 of the June 2, 2009 and the June 17, 2009 orders, and approving the tender of the Appellant on the terms and conditions upon which the Receiver originally sought approval.

R.L. BERGER J.A.
P.A. ROWBOTHAM J.A.
R.P. BELZIL J. (ad hoc)

cp/e/qlcct/qlpwb/qlaxw/qlced/qlcas/qlhcs

TAB "12"

LEXSEE 818 A2D 914

OMNICARE, INC., Plaintiff Below, Appellant, v. NCS HEALTHCARE, INC., JON H. OUTCALT, KEVIN B. SHAW, BOAKE A. SELLS, RICHARD L. OSBORNE, GENESIS HEALTH VENTURES, INC., and GENEVA SUB, INC., Defendants Below, Appellee. ROBERT M. MILES, GUILLERMA MARTI, ANTHONY NOBLE, JEFFREY TREADWAY, TILLIE SALTZMAN, DOLPHIN LIMITED PARTNERSHIP I, L.P., RAMESH MEHAN, RENEE MEHAN, RENEE MEHAN IRA, SAROJ MEHAN, MANEESH MEHAN, RAHUL MEHAN, JOEL MEHAN, LAJIA MEHAN, DARSHAN MEHAN IRA, DANSHAL MEHAN (ROLLOVER IRA), ARSH N. MEHAN, ARSH N. MEHAN (ROTH IRA), ASHOK K. MEHAN, and ASHOK K. MEHAN IRA, Plaintiffs Below, Appellants, v. JON H. OUTCALT, KEVIN E. SHAW, BOAKE A. SELLS, RICHARD L. OSBORNE, GENESIS HEALTH VENTURES, INC., GENESIS SUB, INC., and NCS HEALTHCARE, INC., Defendants Below, Appellees.

No. 605, 2002, No. 649, 2002 CONSOLIDATED

SUPREME COURT OF DELAWARE

818 A.2d 914; *2003 Del. LEXIS 195*

December 10, 2002, Submitted
April 4, 2003, Decided

SUBSEQUENT HISTORY: Costs and fees proceeding at *In re NCS Healthcare, Inc. S'holders Litig., 2003 Del. Ch. LEXIS 56 (Del. Ch., May 28, 2003)*

PRIOR HISTORY: [**1] Court Below-Court of Chancery of the State of Delaware, in and for New Castle County. C.A. No. 19800. C.A. No. 19786.
Omni Care, Inc. v. NCS Healthcare, Inc., 2002 Del. LEXIS 723 (Del., Dec. 10, 2002)
In re NCS Healthcare, Inc. S'holders Litig., 825 A.2d 240, 2002 Del. Ch. LEXIS 133 (Del. Ch., 2002)
Omnicare, Inc. v. NCS Healthcare, Inc., 809 A.2d 1163, 2002 Del. Ch. LEXIS 120 (Del. Ch., 2002)
Omnicare, Inc. v. NCS Healthcare, Inc., 825 A.2d 264, 2002 Del. Ch. LEXIS 131 (Del. Ch., 2002)

DISPOSITION: Reversed and remanded.

COUNSEL: Donald J. Wolfe, Jr. (argued), Esquire, Kevin R. Shannon, Esquire, Michael A. Pittenger, Esquire, John M. Seaman, Esquire, Richard L. Renck, Esquire, of Potter, Anderson & Corroon, Wilmington, Delaware, for appellant.

Edward P. Welch, Esquire (argued), Edward B. Micheletti, Esquire, Katherine J. Neikirk, Esquire, James A. Whitney, Esquire, of Skadden, Arps, Slate, Meagher & Flom, Wilmington, Delaware, Mark A. Phillips, Esquire, of Benesch, Friedlander, Coplan & Aronoff, Cleveland, Ohio, for appellees, NCS HealthCare, Inc., Boake A. Sells and Richard L. Osborne.

David C. McBride, Esquire (argued), Bruce L. Silverstein, Esquire, Christian Douglas Wright, Esquire, Adam W. Poff, Esquire, of Young, Conaway, Stargatt & Taylor, Wilmington, Delaware, Paul Vizcarrondo, Jr., Esquire, Theodore N. Mirvis, Esquire (argued), Mark Gordon, Esquire, John F. Lynch, Esquire, Lauryn P. Gouldin, Esquire, [**2] of Wachtell, Lipton, Rosen & Katz, New York, New York, attorneys for Genesis Health Ventures, Inc. and Geneva Sub, Inc.

Edward M. McNally, Esquire, Michael A. Weidinger, Esquire, Elizabeth A. Brown, Esquire, of Morris, James, Hitchens & Williams,

Wilmington, Delaware, Timothy G. Warner, Esquire, and James R. Bright, Esquire, of Spieth, Bell, McCurdy & Newell Co., Cleveland, OH, for defendant, Kevin B. Shaw.

Jon E. Abramczyk, Esquire, Brian J. McTear, Esquire, of Morris, Nichols, Arsht & Tunnell, Wilmington, Delaware, Frances Floriano Goins, Esquire, and Thomas G. Kovach, Esquire, of Squire, Sanders & Dempsey, Cleveland, OH 44114, for defendant, Jon H. Outcalt.

Joseph A. Rosenthal, Esquire (argued), Carmella P. Keener, Esquire, of Rosenthal, Monhait, Gross & Goddess, P. A., Wilmington, Delaware, Daniel A. Osborn, Esquire of Beatie and Osborn, New York, NY 10175 and Richard B. Bemporad, Lowey, Dannenberg, Bemporad & Selinger, White Plains, NY, liaison counsel for plaintiffs.

Robert J. Kriner, Jr., Esquire, of Chimicles & Tikellis, LLP, Wilmington, Delaware, liaison counsel for plaintiffs.

JUDGES: Before VEASEY, Chief Justice, WALSH, HOLLAND, BERGER and STEELE, Justices, [**3] constituting the Court.

OPINION BY: HOLLAND

OPINION

[*917] **HOLLAND**, Justice, for the majority:

NCS Healthcare, Inc. ("NCS"), a Delaware corporation, was the object of competing acquisition bids, one by Genesis Health Ventures, Inc. ("Genesis"), a Pennsylvania corporation, and the other by Omnicare, Inc. ("Omnicare"), a Delaware corporation. The proceedings before this Court were expedited due to exigent circumstances, including the pendency of the stockholders' meeting to consider the NCS/Genesis merger agreement. The determinations of this Court were set forth in a summary manner following oral argument to provide clarity and certainty to the parties going forward. Those determinations are explicated in this opinion.

[*918] **Overview of Opinion**

The board of directors of NCS, an insolvent publicly traded Delaware corporation, agreed to the terms of a merger with Genesis. Pursuant to that agreement, all of the NCS creditors would be paid in full and the corporation's stockholders would exchange their shares for the shares of Genesis, a publicly traded Pennsylvania corporation. Several months after approving the merger agreement, but before the stockholder vote was scheduled, the NCS [**4] board of directors withdrew its prior recommendation in favor of the Genesis merger.

In fact, the NCS board recommended that the stockholders reject the Genesis transaction after deciding that a competing proposal from Omnicare was a superior transaction. The competing Omnicare bid offered the NCS stockholders an amount of cash equal to more than twice the then current market value of the shares to be received in the Genesis merger. The transaction offered by Omnicare also treated the NCS corporation's other stakeholders on equal terms with the Genesis agreement.

The merger agreement between Genesis and NCS contained a provision authorized by *Section 251(c)* of Delaware's corporation law. It required that the Genesis agreement be placed before the corporation's stockholders for a vote, even if the NCS board of directors no longer recommended it. [1] At the insistence of Genesis, the NCS board also agreed to omit any effective fiduciary clause from the merger agreement. In connection with the Genesis merger agreement, two stockholders of NCS, who held a majority of the voting power, agreed unconditionally to vote all of their shares in favor of the Genesis merger. Thus, the combined [**5] terms of the voting agreements and merger agreement guaranteed, *ab initio*, that the transaction proposed by Genesis would obtain NCS stockholder's approval.

1 *Del. Code Ann. tit. 8, § 251(c).*

The Court of Chancery ruled that the voting agreements, when coupled with the provision in the Genesis merger agreement requiring that it be presented to the stockholders for a vote pursuant to *8 Del. C. § 251(c)*, constituted defensive measures within the meaning of *Unocal Corp. v. Mesa Petroleum Co.* [2] After applying the *Unocal* standard of enhanced judicial scrutiny, the Court of Chancery held that those defensive measures were reasonable. We have concluded that, in the absence of an effective fiduciary out clause, those defensive measures are both preclusive and coercive. Therefore, we hold that those defensive measures are invalid and unenforceable.

The Parties

2 *Unocal Corp. v Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). See also Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1386-89 (Del. 1995).*

[**6] The defendant, NCS, is a Delaware corporation headquartered in Beachwood, Ohio. NCS is a leading independent provider of pharmacy services to long-term care institutions including skilled nursing facilities, assisted living facilities and other institutional healthcare facilities. NCS common stock consists of Class A shares and Class B shares. The Class B shares are entitled to ten votes per share and the Class A shares are entitled to one vote per share. The shares are virtually identical in every other respect.

The defendant Jon H. Outcalt is Chairman of the NCS board of directors. Outcalt owns 202,063 shares of NCS Class A common stock and 3,476,086 shares of Class B common stock. The defendant [*919] Kevin B. Shaw is President, CEO and a director of NCS. At the time the merger agreement at issue in this dispute was executed with Genesis, Shaw owned 28,905 shares of NCS Class A common stock and 1,141,134 shares of Class B common stock.

The NCS board has two other members, defendants Boake A. Sells and Richard L. Osborne. Sells is a graduate of the Harvard Business School. He was Chairman and CEO at Revco Drugstores in Cleveland, Ohio from 1987 to 1992, when he was replaced by new owners. [**7] Sells currently sits on the boards of both public and private companies. Osborne is a full-time professor at the Weatherhead School of Management at Case Western Reserve University. He has been at the university for over thirty years. Osborne currently sits on at least seven corporate boards other than NCS.

The defendant Genesis is a Pennsylvania corporation with its principal place of business in Kennett Square, Pennsylvania. It is a leading provider of healthcare and support services to the elderly. The defendant Geneva Sub, Inc., a wholly owned subsidiary of Genesis, is a Delaware corporation formed by Genesis to acquire NCS.

The plaintiffs in the class action own an unspecified number of shares of NCS Class A common stock. They represent a class consisting of all holders of Class A common stock. As of July 28, 2002, NCS had 18,461,599 Class A shares and 5,255,210 Class B shares outstanding.

Omnicare is a Delaware corporation with its principal place of business in Covington, Kentucky. Omnicare is in the institutional pharmacy business, with annual sales in excess of $ 2.1 billion during its last fiscal year. Omnicare purchased 1000 shares of NCS Class A common stock on July 30, 2002.

[**8] *PROCEDURAL BACKGROUND*

This is a consolidated appeal from orders of the Court of Chancery in two separate proceedings. One proceeding is brought by Omnicare seeking to invalidate a merger agreement between NCS and Genesis on fiduciary duty grounds. In that proceeding, Omnicare also challenges Voting Agreements between Genesis and Jon H. Outcalt and Kevin B. Shaw, two major NCS stockholders, who collectively own over 65% of the voting power of NCS stock. The Voting Agreements irrevocably commit these stockholders to vote for the merger. The Omnicare action was C.A. No. 19800 in the Court of Chancery and is No. 605, 2002, in this Court.

The other proceeding is a class action brought by NCS stockholders. That action seeks to invalidate the merger primarily on the ground that the directors of NCS violated their fiduciary duty of care in failing to establish an effective process designed to achieve the transaction that would produce the highest value for the NCS stockholders. The stockholder action was C.A. No. 19786 in the Court of Chancery and is No. 649, 2002 in this Court.

Standing Decision

In Appeal No. 605, 2002 (the "Omnicare appeal") the Court of Chancery [**9] entered two orders. The first decision and order (the "Standing Decision"), dated October 25, 2002, dismissed Omnicare's fiduciary duty claims because it lacked standing to assert those claims. The Court of Chancery refused to dismiss Omnicare's declaratory judgment claim, holding that Omnicare had standing, notwithstanding the timing of its purchase of NCS stock to assert its claim, as a bona fide bidder for control, that the NCS charter should be interpreted to cause an automatic conversion of Outcalt's and Shaw's Class B stock [*920] (with ten votes per share) to Class A stock (with one vote per share).

Voting Agreements Decision

The second decision and order of the Court of Chancery that is before this Court in the Omnicare appeal is the Court of Chancery's order of October 29, 2002 (the "Voting Agreements Decision") adjudicating the merits of the Voting Agreements. With regard to that issue, the Court of Chancery held Omnicare had standing, as set forth in the preceding paragraph. In the Voting Agreements decision on summary judgment, the Court of Chancery interpreted the applicable NCS charter provisions adversely to Omnicare's contention that the irrevocable proxies granted [**10] in those agreements by Outcalt and Shaw to vote for the Genesis merger resulted in an automatic conversion of all of Outcalt's and Shaw's Class B stock into Class A stock. Omnicare's claim with respect to the Voting Agreements was, therefore, dismissed by the Court of Chancery.

Fiduciary Duty Decision

A class action to enjoin the merger was brought by certain stockholders of NCS in the Court of chancery in C.A. No. 19786. The Court of Chancery denied a preliminary injunction in a decision and order dated November 22, 2002, and revised November 25, 2002 (the "Fiduciary Duty Decision"). That decision is now before this Court upon interlocutory review in Appeal No. 649, 2002. The standing of these stockholders to seek injunctive relief based on alleged violations of fiduciary duties by the NCS directors in approving the proposed merger is apparently not challenged by the defendants. Accordingly, the fiduciary duty claims, including those claims Omnicare sought to assert are being asserted by the class action plaintiffs.

FACTUAL BACKGROUND

The parties are in substantial agreement regarding the operative facts. They disagree, however, about the legal implications. [**11] This recitation of facts is taken primarily from the opinion by the Court of Chancery.

NCS Seeks Restructuring Alternatives

Beginning in late 1999, changes in the timing and level of reimbursements by government and third-party providers adversely affected market conditions in the health care industry. As a result, NCS began to experience greater difficulty in collecting accounts receivables, which led to a precipitous decline in the market value of its stock. NCS common

shares that traded above $ 20 in January 1999 were worth as little as $ 5 at the end of that year. By early 2001, NCS was in default on approximately $ 350 million in debt, including $ 206 million in senior bank debt and $ 102 million of its 5 3/4 %Convertible Subordinated Debentures (the "Notes"). After these defaults, NCS common stock traded in a range of $ 0.09 to $ 0.50 per share until days before the announcement of the transaction at issue in this case.

NCS began to explore strategic alternatives that might address the problems it was confronting. As part of this effort, in February 2000, NCS retained UBS Warburg, L.L.C. to identify potential acquirers and possible equity investors. UBS Warburg contacted [**12] over fifty different entities to solicit their interest in a variety of transactions with NCS. UBS Warburg had marginal success in its efforts. By October 2000, NCS had only received one non-binding indication of interest valued at $ 190 million, substantially less than the face value of NCS's senior debt. This proposal was reduced by 20% after the offeror conducted its due diligence review.

[*921] **NCS Financial Deterioration**

In December 2000, NCS terminated its relationship with UBS Warburg and retained Brown, Gibbons, Lang & Company as its exclusive financial advisor. During this period, NCS's financial condition continued to deteriorate. In April 2001, NCS received a formal notice of default and acceleration from the trustee for holders of the Notes. As NCS's financial condition worsened, the Noteholders formed a committee to represent their financial interests (the "Ad Hoc Committee"). At about that time, NCS began discussions with various investor groups regarding a restructuring in a "pre-packaged" bankruptcy. NCS did not receive any proposal that it believed provided adequate consideration for its stakeholders. At that time, full recovery for NCS's creditors was a remote [**13] prospect, and any recovery for NCS stockholders seemed impossible.

Omnicare's Initial Negotiations

In the summer of 2001, NCS invited Omnicare, Inc. to begin discussions with Brown Gibbons regarding a possible transaction. On July 20, Joel Gemunder, Omnicare's President and CEO, sent Shaw a written proposal to acquire NCS in a bankruptcy sale under *Section 363 of the Bankruptcy Code.* This proposal was for $ 225 million subject to satisfactory completion of due diligence. NCS asked Omnicare to execute a confidentiality agreement so that more detailed discussions could take place. [3]

3 Discovery had revealed that, at the same time, Omnicare was attempting to lure away NCS's customers through what it characterized as the "NCS Blitz." The "NCS Blitz" was an effort by Omnicare to target NCS's customers. Omnicare has engaged in an "NCS Blitz" a number of times, most recently while NCS and Omnicare were in discussions in July and August 2001.

In August 2001, Omnicare increased its bid to $ 270 million, [**14] but still proposed to structure the deal as an asset sale in bankruptcy. Even at $ 270 million, Omnicare's proposal was substantially lower than the face value of NCS's outstanding debt. It would have provided only a small recovery for Omnicare's Noteholders and no recovery for its stockholders. In October 2001, NCS sent Glen Pollack of Brown Gibbons to meet with Omnicare's financial advisor, Merrill Lynch, to discuss Omnicare's interest in NCS. Omnicare responded that it was not interested in any transaction other than an asset sale in bankruptcy.

There was no further contact between Omnicare and NCS between November 2001 and January 2002. Instead, Omnicare began secret discussions with Judy K. Mencher, a representative of the Ad Hoc Committee. In these discussions, Omnicare continued to pursue a transaction structured as a sale of assets in bankruptcy. In February 2002, the Ad Hoc Committee notified the NCS board that Omnicare had proposed an asset sale in bankruptcy for $ 313,750,000.

NCS Independent Board Committee

In January 2002, Genesis was contacted by members of the Ad Hoc Committee concerning a possible transaction

with NCS. Genesis executed NCS's standard confidentiality [**15] agreement and began a due diligence review. Genesis had recently emerged from bankruptcy because, like NCS, it was suffering from dwindling government reimbursements.

Genesis previously lost a bidding war to Omnicare in a different transaction. This led to bitter feelings between the principals of both companies. More importantly, this bitter experience for Genesis led to its insistence on exclusivity agreements and lock-ups in any potential transaction with NCS.

[*922] **NCS Financial Improvement**

NCS's operating performance was improving by early 2002. As NCS's performance improved, the NCS directors began to believe that it might be possible for NCS to enter into a transaction that would provide some recovery for NCS stockholders' equity. In March 2002, NCS decided to form an independent committee of board members who were neither NCS employees nor major NCS stockholders (the "Independent Committee"). The NCS board thought this was necessary because, due to NCS's precarious financial condition, it felt that fiduciary duties were owed to the enterprise as a whole rather than solely to NCS stockholders.

Sells and Osborne were selected as the members of the committee, and given [**16] authority to consider and negotiate possible transactions for NCS. The entire four member NCS board, however, retained authority to approve any transaction. The Independent Committee retained the same legal and financial counsel as the NCS board.

The Independent Committee met for the first time on May 14, 2002. At that meeting Pollack suggested that NCS seek a "stalking-horse merger partner" to obtain the highest possible value in any transaction. The Independent Committee agreed with the suggestion.

Genesis Initial Proposal

Two days later, on May 16, 2002, Scott Berlin of Brown Gibbons, Glen Pollack and Boake Sells met with George Hager, CFO of Genesis, and Michael Walker, who was Genesis's CEO. At that meeting, Genesis made it clear that if it were going to engage in any negotiations with NCS, it would not do so as a "stalking horse." As one of its advisors testified, "We didn't want to be someone who set forth a valuation for NCS which would only result in that valuation ...being publicly disclosed, and thereby creating an environment where Omnicare felt to maintain its competitive monopolistic positions, that they had to match and exceed that level." Thus, Genesis [**17] "wanted a degree of certainty that to the extent [it] was willing to pursue a negotiated merger agreement ..., [it] would be able to consummate the transaction [it] negotiated and executed."

In June 2002, Genesis proposed a transaction that would take place outside the bankruptcy context. Although it did not provide full recovery for NCS's Noteholders, it provided the possibility that NCS stockholders would be able to recover something for their investment. As discussions continued, the terms proposed by Genesis continued to improve. On June 25, the economic terms of the Genesis proposal included repayment of the NCS senior debt in full, full assumption of trade credit obligations, an exchange offer or direct purchase of the NCS Notes providing NCS Noteholders with a combination of cash and Genesis common stock equal to the par value of the NCS Notes (not including accrued interest), and $ 20 million in value for the [*923] NCS common stock. Structurally, the Genesis proposal continued to include consents from a significant majority of the Noteholders as well as support agreements from stockholders owning a majority of the NCS voting power.

Genesis Exclusivity Agreement

[**18] NCS's financial advisors and legal counsel met again with Genesis and its legal counsel on June 26, 2002, to discuss a number of transaction-related issues. At this meeting, Pollack asked Genesis to increase its offer to NCS stockholders. Genesis agreed to consider this request. Thereafter, Pollack and Hager had further conversations. Genesis agreed to offer a total of $ 24 million in consideration for the NCS common stock, or an additional $ 4 million, in the

form of Genesis common stock.

At the June 26 meeting, Genesis's representatives demanded that, before any further negotiations take place, NCS agree to enter into an exclusivity agreement with it. As Hager from Genesis explained it: "[I] f they wished us to continue to try to move this process to a definitive agreement, that they would need to do it on an exclusive basis with us. We were going to, and already had incurred significant expense, but we would incur additional expenses ..., both internal and external, to bring this transaction to a definitive signing. We wanted them to work with us on an exclusive basis for a short period of time to see if we could reach agreement." On June 27, 2002, Genesis's legal counsel delivered [**19] a draft form of exclusivity agreement for review and consideration by NCS's legal counsel.

The Independent Committee met on July 3, 2002, to consider the proposed exclusivity agreement. Pollack presented a summary of the terms of a possible Genesis merger, which had continued to improve. The then-current Genesis proposal included (1) repayment of the NCS senior debt in full, (2) payment of par value for the Notes (without accrued interest) in the form of a combination of cash and Genesis stock, (3) payment to NCS stockholders in the form of $ 24 million in Genesis stock, plus (4) the assumption, because the transaction was to be structured as a merger, of additional liabilities to trade and other unsecured creditors.

NCS director Sells testified, Pollack told the Independent Committee at a July 3, 2002 meeting that Genesis wanted the Exclusivity Agreement to be the first step towards a completely locked up transaction that would preclude a higher bid from Omnicare:

> A. [Pollack] explained that Genesis felt that they had suffered at the hands of Omnicare and others. I guess maybe just Omnicare. I don't know much about Genesis [sic] acquisition history. But they had suffered [**20] before at the 11: 59: 59 and that they wanted to have a pretty much bulletproof deal or they were not going to go forward.
>
> Q. When you say they suffered at the hands of Omnicare, what do you mean?
>
> A. Well, my expression is that that was related to a deal that was related to me or explained to me that they, Genesis, had tried to acquire, I suppose, an institutional pharmacy, I don't remember the name of it. Thought they had a deal and then at the last minute, Omnicare outbid them for the company in a like 11: 59 kind of thing, and that they were unhappy about that. And once burned, twice shy.

After NCS executed the exclusivity agreement, Genesis provided NCS with a draft merger agreement, a draft Noteholders' support agreement, and draft voting agreements for Outcalt and Shaw, who together held a majority of the voting power of the NCS common stock. Genesis and NCS negotiated the terms of the merger agreement over the next three weeks. During those negotiations, the Independent Committee and the Ad Hoc Committee persuaded Genesis to improve the terms of its merger.

The parties were still negotiating by July 19, and the exclusivity period was automatically extended to July 26. [**21] At that point, NCS and Genesis were close to executing a merger agreement and related voting agreements. Genesis proposed a short extension of the exclusivity agreement so a deal could be finalized. On the morning of July 26, 2002, the Independent Committee authorized an extension of the exclusivity period through July 31.

[*924] **Omnicare Proposes Negotiations**

By late July 2002, Omnicare came to believe that NCS was negotiating a transaction, possibly with Genesis or another of Omnicare's competitors, that would potentially present a competitive threat to Omnicare. Omnicare also came to believe, in light of a run-up in the price of NCS common stock, that whatever transaction NCS was negotiating probably included a payment for its stock. Thus, the Omnicare board of directors met on the morning of July 26 and, on the recommendation of its management, authorized a proposal to acquire NCS that did not involve a sale of assets in

bankruptcy.

On the afternoon of July 26, 2002, Omnicare faxed to NCS a letter outlining a proposed acquisition. The letter suggested a transaction in which Omnicare would retire NCS's senior and subordinated debt at par plus accrued interest, and pay the [**22] NCS stockholders $ 3 cash for their shares. Omnicare's proposal, however, was expressly conditioned on negotiating a merger agreement, obtaining certain third party consents, and completing its due diligence.

Mencher saw the July 26 Omnicare letter and realized that, while its economic terms were attractive, the "due diligence" condition substantially undercut its strength. In an effort to get a better proposal from Omnicare, Mencher telephoned Gemunder and told him that Omnicare was unlikely to succeed in its bid unless it dropped the "due diligence outs." She explained this was the only way a bid at the last minute would be able to succeed. Gemunder considered Mencher's warning "very real," and followed up with his advisors. They, however, insisted that he retain the due diligence condition "to protect [him] from doing something foolish." Taking this advice to heart, Gemunder decided not to drop the due diligence condition.

Late in the afternoon of July 26, 2002, NCS representatives received voicemail messages from Omnicare asking to discuss the letter. The exclusivity agreement prevented NCS from returning those calls. In relevant part, that agreement precluded NCS from "engaging [**23] or particpating in any discussions or negotiations with respect to a Competing Transaction or a proposal for one." The July 26 letter from Omnicare met the definition of a "Competing Transaction."

Despite the exclusivity agreement, the Independent Committee met to consider a response to Omnicare. It concluded that discussions with Omnicare about its July 26 letter presented an unacceptable risk that Genesis would abandon merger discussions. The Independent Committee believed that, given Omnicare's past bankruptcy proposals and unwillingness to consider a merger, as well as its decision to negotiate exclusively with the Ad Hoc Committee, the risk of losing the Genesis proposal was too substantial. Nevertheless, the Independent Committee instructed Pollack to use Omnicare's letter to negotiate for improved terms with Genesis.

Genesis Merger Agreement And Voting Agreements

Genesis responded to the NCS request to improve its offer as a result of the Omnicare fax the next day. On July 27, Genesis proposed substantially improved terms. First, it proposed to retire the Notes in accordance with the terms of the indenture, thus eliminating the need for Noteholders to consent to [**24] the transaction. This change involved paying all accrued interest plus a small redemption premium. Second, Genesis increased the exchange ratio for NCS common stock to one-tenth of a Genesis common share for each NCS common share, an 80% increase. Third, it agreed to lower the proposed termination [*925] fee in the merger agreement from $ 10 million to $ 6 million. In return for these concessions, Genesis stipulated that the transaction had to be approved by midnight the next day, July 28, or else Genesis would terminate discussions and withdraw its offer.

The Independent Committee and the NCS board both scheduled meetings for July 28. The committee met first. Although that meeting lasted less than an hour, the Court of Chancery determined the minutes reflect that the directors were fully informed of all material facts relating to the proposed transaction. After concluding that Genesis was sincere in establishing the midnight deadline, the committee voted unanimously to recommend the transaction to the full board.

The full board met thereafter. After receiving similar reports and advice from its legal and financial advisors, the board concluded that "balancing the potential loss of the [**25] Genesis deal against the uncertainty of Omnicare's letter, results in the conclusion that the only reasonable alternative for the Board of Directors is to approve the Genesis transaction." The board first voted to authorize the voting agreements with Outcalt and Shaw, for purposes of *Section 203 of the Delaware General Corporation Law* (" DGCL"). The board was advised by its legal counsel that "under the terms of the merger agreement and because NCS shareholders representing in excess of 50% of the outstanding voting power would be *required* by Genesis to enter into stockholder voting agreements contemporaneously with the signing of the merger agreement, and would agree to vote their shares in favor of the merger agreement, shareholder approval of

the merger would be assured even if the NCS Board were to withdraw or change its recommendation. *These facts would prevent NCS from engaging in any alternative or superior transaction in the future.*" (emphasis added).

After listening to a *summary* of the merger terms, the board then resolved that the merger agreement and the transactions contemplated thereby were advisable and fair and in the best interests of all the NCS stakeholders. [**26] The NCS board further resolved to recommend the transactions to the stockholders for their approval and adoption. A definitive merger agreement between NCS and Genesis and the stockholder voting agreements were executed later that day. The Court of Chancery held that it was not a *per se* breach of fiduciary duty that the NCS board never read the NCS/Genesis merger agreement word for word. [4]

4 *See, e. g., Smith v. Van Gorkom, 488 A.2d 858, 883 n. 25 (Del. 1985).*

NCS/Genesis Merger Agreement

Among other things, the NCS/Genesis merger agreement provided the following:

-NCS stockholders would receive 1 share of Genesis common stock in exchange for every 10 shares of NCS common stock held;

-NCS stockholders could exercise appraisal rights under *8 Del. C. § 262*;

-NCS would redeem NCS's Notes in accordance with their terms;

-NCS would submit the merger agreement to NCS stockholders regardless of whether the NCS board continued to [**27] recommend the merger;

-NCS would not enter into discussions with third parties concerning an alternative acquisition of NCS, or provide non-public information to such parties, unless (1) the third party provided an unsolicited, *bona fide* written proposal documenting the terms of the acquisition; (2) the NCS board believed in good faith that the proposal was or was likely to result in an acquisition on terms superior [*926] to those contemplated by the NCS/Genesis merger agreement; and (3) before providing non-public information to that third party, the third party would execute a confidentiality agreement at least as restrictive as the one in place between NCS and Genesis; and

-If the merger agreement were to be terminated, under certain circumstances NCS would be required to pay Genesis a $ 6 million termination fee and/or Genesis's documented expenses, up to $ 5 million.

Voting Agreements

Outcalt and Shaw, in their capacity as NCS stockholders, entered into voting agreements with Genesis. NCS was also required to be a party to the voting agreements by Genesis. Those agreements provided, among other things, that:

-Outcalt and Shaw were acting in their capacity as [**28] NCS stockholders in executing the agreements, not in their capacity as NCS directors or officers;

-Neither Outcalt nor Shaw would transfer their shares prior to the stockholder vote on the merger agreement;

-Outcalt and Shaw agreed to vote all of their shares in favor of the merger agreement; and

-Outcalt and Shaw granted to Genesis an irrevocable proxy to vote their shares in favor of the

merger agreement.

-The voting agreement was specifically enforceable by Genesis.

The merger agreement further provided that if either Outcalt or Shaw breached the terms of the voting agreements, Genesis would be entitled to terminate the merger agreement and potentially receive a $ 6 million termination fee from NCS. Such a breach was impossible since Section 6 provided that the voting agreements were specifically enforceable by Genesis.

Omnicare's Superior Proposal

On July 29, 2002, hours after the NCS/Genesis transaction was executed, Omnicare faxed a letter to NCS restating its conditional proposal and attaching a draft merger agreement. Later that morning, Omnicare issued a press release publicly disclosing the proposal.

On August 1, 2002, Omnicare filed a lawsuit attempting [**29] to enjoin the NCS/Genesis merger, and announced that it intended to launch a tender offer for NCS's shares at a price of $ 3.50 per share. On August 8, 2002, Omnicare began its tender offer. By letter dated that same day, Omnicare expressed a desire to discuss the terms of the offer with NCS. Omnicare's letter continued to condition its proposal on satisfactory completion of a due diligence investigation of NCS.

On August 8, 2002, and again on August 19, 2002, the NCS Independent Committee and full board of directors met separately to consider the Omnicare tender offer in light of the Genesis merger agreement. NCS's outside legal counsel and [*927] NCS's financial advisor attended both meetings. The board was unable to determine that Omnicare's expressions of interest were likely to lead to a "Superior Proposal," as the term was defined in the NCS/Genesis merger agreement. On September 10, 2002, NCS requested and received a waiver from Genesis allowing NCS to enter into discussions with Omnicare without first having to determine that Omnicare's proposal was a "Superior Proposal."

On October 6, 2002, Omnicare irrevocably committed itself to a transaction with NCS. Pursuant to the terms of [**30] its proposal, Omnicare agreed to acquire all the outstanding NCS Class A and Class B shares at a price of $ 3.50 per share in cash. As a result of this irrevocable offer, on October 21, 2002, the NCS board withdrew its recommendation that the stockholders vote in favor of the NCS/Genesis merger agreement. NCS's financial advisor withdrew its fairness opinion of the NCS/Genesis merger agreement as well.

Genesis Rejection Impossible

The Genesis merger agreement permits the NCS directors to furnish non-public information to, or enter into discussions with, "any Person in connection with an unsolicited bona fide written Acquisition Proposal by such person" that the board deems likely to constitute a "Superior Proposal." That provision has absolutely no effect on the Genesis merger agreement. Even if the NCS board "changes, withdraws or modifies" its recommendation, as it did, it must still submit the merger to a stockholder vote.

A subsequent filing with the Securities and Exchange Commission ("SEC") states: "the NCS independent committee and the NCS board of directors have determined to withdraw their recommendations of the Genesis merger agreement and recommend that the [**31] NCS stockholders vote against the approval and adoption of the Genesis merger." In that same SEC filing, however, the NCS board explained why the success of the Genesis merger had already been predetermined. "Notwithstanding the foregoing, the NCS independent committee and the NCS board of directors recognize that (1) the existing contractual obligations to Genesis currently prevent NCS from accepting the Omnicare irrevocable merger proposal; and (2) the existence of the voting agreements entered into by Messrs. Outcalt and Shaw, whereby Messrs. Outcalt and Shaw agreed to vote their shares of NCS Class A common stock and NCS Class B common stock in favor of the Genesis merger, ensure NCS stockholder approval of the Genesis merger." This

litigation was commenced to prevent the consummation of the inferior Genesis transaction.

LEGAL ANALYSIS

Business Judgment or Enhanced Scrutiny

The "defining tension" in corporate governance today has been characterized as "the tension between deference to directors' decisions and the scope of judicial review." [5] The appropriate standard of judicial review is dispositive of which party has the burden of proof as any litigation proceeds [**32] from stage to stage until there is a substantive determination on the merits. [6] Accordingly, identification of the correct analytical framework is essential to a proper judicial review of challenges to the decision-making process of a corporation's board of directors. [7]

5 E. Norman Veasey, *The Defining Tension in Corporate Governance in America, 52 Bus. Law. 393, 403 (1997).*
6 *Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1371 (Del. 1995). See, e. g., Malpiede v. Townson, 780 A.2d 1075 (Del. 2001)*; *Emerald Partners v. Berlin, 787 A.2d 85 (Del. 2001)*; *Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995)*; *Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110 (1994).*
7 *Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d at 1374.*

"The business judgment rule, as a standard of judicial review, is a common-law recognition of the statutory authority to manage a corporation that is [**33] vested in the board of directors." [8] 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." [9] "An application of the [*928] traditional business judgment rule places the burden on the 'party challenging the [board's] decision to establish facts rebutting the presumption. '" [10] The effect of a proper invocation of the business judgment rule, as a standard of judicial review, is powerful because it operates deferentially. Unless the procedural presumption of the business judgment rule is rebutted, a "court will not substitute its judgment for that of the board if the [board's] decision can be 'attributed to any rational business purpose. '" [11]

8 *MM Companies v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003).*
9 *Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d at 1373* (quoting *Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).*
10 *Id.*
11 *Id. at 1373* (quoting *Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)* (citation omitted)).

[**34] The business judgment rule embodies the deference that is accorded to managerial decisions of a board of directors. "Under normal circumstances, neither the courts nor the stockholders should interfere with the managerial decision of the directors." [12] There are certain circumstances, however, "which mandate that a court take a more direct and active role in overseeing the decisions made and actions taken by directors. In these situations, a court subjects the directors' conduct to enhanced scrutiny to ensure that it is reasonable," [13] "before the protections of the business judgment rule may be conferred." [14]

12 *Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del. 1993).*
13 *Id.* (footnote omitted).
14 *Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 954.*

The prior decisions of this Court have identified the circumstances where board action must be subjected to enhanced judicial scrutiny before the presumptive protection of the business [**35] judgment rule can be invoked. One of those circumstances was described in *Unocal*: when a board adopts defensive measures in response to a hostile takeover proposal that the board reasonably determines is a threat to corporate policy and effectiveness. [15] In *Moran v. Household*, we explained why a *Unocal* analysis also was applied to the adoption of a stockholder's rights plan, even in the absence of an immediate threat. [16] Other circumstances requiring enhanced judicial scrutiny give rise to what are

known as *Revlon* duties, such as when the board enters into a merger transaction that will cause a change in corporate control, initiates an active bidding process seeking to sell the corporation, or makes a break up of the corporate entity inevitable. [17]

Merger Decision Review Standard

15 *Id. at 954-55.*
16 *Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985).*
17 *Paramount Communications Inc. v. QVC Network Inc., 637 A.2d at 47*; *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).*

[**36] The first issue decided by the Court of Chancery addressed the standard of judicial review that should be applied to the decision by the NCS board to merge with Genesis. This Court has held that a board's decision to enter into a merger transaction that does not involve a change in control is entitled to judicial deference pursuant to the procedural and substantive operation of the business judgment rule. [18] When a board decides to enter into a merger transaction that will result in a change of control, however, enhanced judicial scrutiny under *Revlon* is the standard of review. [19]

18 *Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1152 (Del. 1989).*
19 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).*

[*929] The Court of Chancery concluded that, because the stock-for-stock merger between Genesis and NCS did not result in a change of control, the NCS directors' duties under *Revlon* were not triggered by the decision to [**37] merge with Genesis. [20] The Court of Chancery also recognized, however, that *Revlon* duties are imposed "when a corporation initiates an active bidding process seeking to sell itself." [21] The Court of Chancery then concluded, alternatively, that *Revlon* duties had not been triggered because NCS did not start an active bidding process, and the NCS board "abandoned" its efforts to sell the company when it entered into an exclusivity agreement with Genesis.

20 *See id.*
21 *Arnold v. Soc'y for Sav. Bancorp, Inc., 650 A.2d 1270, 1290 (Del. 1994)* (quoting *Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989)*); *see also Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 at 1287*; *McMullin v. Beran, 765 A.2d 910, 919-20 (Del. 2000)* (finding *Revlon* duties were implicated where the board agreed to sell the entire company, even though the merger did not involve a "change of control").

After concluding that the [**38] *Revlon* standard of enhanced judicial review was completely inapplicable, the Court of Chancery then held that it would examine the decision of the NCS board of directors to approve the Genesis merger pursuant to the business judgment rule standard. After completing its business judgment rule review, the Court of Chancery held that the NCS board of directors had not breached their duty of care by entering into the exclusivity and merger agreements with Genesis. The Court of Chancery also held, however, that "even applying the more exacting *Revlon* standard, the directors acted in conformity with their fiduciary duties in seeking to achieve the highest and best transaction that was reasonably available to [the stockholders]." [22]

22 *In re NCS Healthcare, Inc., 825 A.2d 240, 2002 Del. Ch. LEXIS 133, 2002 WL 31720732, at *16 (Del. Ch. Nov. 22, 2002). See Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1993).*

The appellants argue that the Court of Chancery's *Revlon* conclusions are [**39] without factual support in the record and contrary to Delaware law for at least two reasons. First, they submit that NCS did initiate an active bidding process. Second, they submit that NCS did not "abandon" its efforts to sell itself by entering into the exclusivity agreement with Genesis. The appellants contend that once NCS decided "to initiate a bidding process seeking to maximize short-term stockholder value, it cannot avoid enhanced judicial scrutiny under *Revlon* simply because the bidder it selected [Genesis] happens to have proposed a merger transaction that does not involve a change of control."

The Court of Chancery's decision to review the NCS board's decision to merge with Genesis under the business judgment rule rather than the enhanced scrutiny standard of *Revlon* is not outcome determinative for the purposes of deciding this appeal. We have assumed arguendo that the business judgment rule applied to the decision by the NCS board to merge with Genesis. [23] We have also assumed arguendo that the NCS board exercised due care when it: abandoned the Independent Committee's recommendation to pursue a stalking horse strategy, without even trying to implement it; executed [**40] an exclusivity agreement with Genesis; acceded to Genesis' twenty-four hour ultimatum for making a final merger decision; and executed a merger agreement that was summarized but never completely read by the NCS board of directors. [24]

23 *Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1152 (Del. 1989).*
24 *But see Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).*

[*930] **Deal Protection Devices Require Enhanced Scrutiny**

The dispositive issues in this appeal involve the defensive devices that protected the Genesis merger agreement. The Delaware corporation statute provides that the board's management decision to enter into and recommend a merger transaction can become final only when ownership action is taken by a vote of the stockholders. Thus, the Delaware corporation law expressly provides for a balance of power between boards and stockholders which makes merger transactions a shared enterprise and ownership decision. Consequently, a board of directors' [**41] decision to adopt defensive devices to protect a merger agreement may implicate the stockholders' right to effectively vote contrary to the initial recommendation of the board in favor of the transaction. [25]

25 *See MM Companies v. Liquid Audio, Inc., 813 A.2d 1118, 1120 (Del. 2003).*

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. [26] The "omnipresent specter" of such conflict may be present whenever a board adopts defensive devices to protect a merger agreement. [27] The stockholders' ability to effectively reject a merger agreement is likely to bear an inversely proportionate relationship to the structural and economic devices that the board has approved to protect the transaction.

26 *Id. at 1129*
27 *See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).*

[**42] In *Paramount v. Time*, the original merger agreement between Time and Warner did not constitute a "change of control." [28] The plaintiffs in *Paramount v. Time* argued that, although the original Time and Warner merger agreement did not involve a change of control, the use of a lock-up, no-shop clause, and "dry-up" provisions violated the Time board's *Revlon* duties. This Court held that "[t] he adoption of structural safety devices alone does not trigger *Revlon*. Rather, as the Chancellor stated, *such devices are properly subject to a Unocal analysis*." [29]

28 *Paramount Communications, Inc. v. Time Inc., 571 A.2d at 1150.*
29 *Id. at 1151* (footnote omitted) (emphasis added).

In footnote 15 of *Paramount v. Time*, we stated that legality of the structural safety devices adopted to protect the original merger agreement between Time and Warner were not a central issue on appeal. [30] That is because the issue on appeal involved the "Time's board [decision] [**43] to recast its consolidation with Warner into an outright cash and securities acquisition of Warner by Time." [31] Nevertheless, we determined that there was substantial evidence on the record to support the conclusions reached by the Chancellor in applying a *Unocal* analysis to each of the structural devices contained in the original merger agreement between Time and Warner. [32]

30 *Id. at 1151 n. 15.*
31 *Id. at 1148.*
32 *Id. at 1151 n. 15.*

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 not approve a merger, and the board's continuing responsibility to effectively exercise its fiduciary duties at all times after the merger agreement is executed. These competing considerations require a threshold determination [*931] that board-approved defensive devices protecting a merger transaction are within the limitations [**44] of its statutory authority and consistent with the directors' fiduciary duties. Accordingly, in *Paramount v. Time*, we held that the business judgment rule applied to the Time board's original decision to merge with Warner. [33] We further held, however, that defensive devices adopted by the board to protect the original merger transaction must withstand enhanced judicial scrutiny under the *Unocal* standard of review, even when that merger transaction does not result in a change of control. [34]

33 *Id. at 1152.*

34 *Id. at 1151-55*; *Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)*; *see In re Santa Fe Pacific Corp. Shareholder Litigation, 669 A.2d 59 (Del. 1995).*

Enhanced Scrutiny Generally

In *Paramount v. QVC*, this Court identified the key features of an enhanced judicial scrutiny test. The first feature is a "judicial determination regarding the adequacy of the decisionmaking process employed by the directors, [**45] including the information on which the directors based their decision." [35] The second feature is "a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing." [36] We also held that "the directors have the burden of proving that they were adequately informed and acted reasonably." [37]

35 *Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1993).*

36 *Id.*

37 *Id.*

In *QVC*, we explained that the application of an enhanced judicial scrutiny test involves a judicial "review of the reasonableness of the substantive merits of the board's actions." [38] In applying that standard, we held that "a court should not ignore the complexity of the directors' task" in the context in which action was taken. [39] Accordingly, we concluded that a court applying enhanced judicial scrutiny should not decide whether the directors made a perfect decision but instead should decide whether "the directors' decision was, [**46] on balance, within a range of reasonableness." [40]

38 *Id.* (footnote omitted).

39 *Id.*

40 *Id.* (citations omitted).

In *Unitrin*, we explained the "ratio *decidendi* for the 'range of reasonableness' standard" [41] when a court applies enhanced judicial scrutiny to director action pursuant to our holding in *Unocal.* [42] It is a recognition that a board of directors needs "latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats." [43] "The concomitant requirement is for judicial restraint." [44] Therefore, if the board of directors' collective defensive responses are not draconian (preclusive or coercive) and are "within a 'range of reasonableness, 'a court must not substitute its judgment for the board's [judgment]." [45] The same *ratio decidendi* applies to the "range of reasonableness" when courts apply *Unocal's* enhanced judicial scrutiny standard to defensive devices intended to [*932] protect a merger agreement [**47] that will not result in a change of control.

41 *Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d at 1388.*

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

43 *Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d at 1388.*

44 *Id.*

45 *Id.* (citation omitted); *see also Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 949, 954-57.*

A board's decision to protect its decision to enter a merger agreement with defensive devices against uninvited competing transactions that may emerge is analogous to a board's decision to protect against dangers to corporate policy and effectiveness when it adopts defensive measures in a hostile takeover contest. In applying *Unocal's* enhanced judicial scrutiny in assessing a challenge to defensive actions taken by a target corporation's board of directors in a takeover context, this Court held that the board "does not have unbridled discretion to defeat perceived threats by any draconian [**48] means available. [46] Similarly, just as a board's statutory power with regard to a merger decision is not absolute, a board does not have unbridled discretion to defeat any perceived threat to a merger by protecting it with any draconian means available.

46 *Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 955.*

Since *Unocal*, "this Court has consistently recognized that defensive measures which are either preclusive or coercive are included within the common law definition of draconian." [47] In applying enhanced judicial scrutiny to defensive actions under *Unocal*, a court must "evaluate the board's overall response, including the justification for each contested defensive measure, and the results achieved thereby." [48] If a "board's defensive actions are inextricably related, the principles of *Unocal* require that such actions be scrutinized collectively as a unitary response to the perceived threat." [49]

47 *Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d at 1387.*
[**49]
48 *Id.*
49 *Id.* (citation omitted).

Therefore, in applying enhanced judicial scrutiny to defensive devices designed to protect a merger agreement, a court must first determine that those measures are not preclusive or coercive *before* its focus shifts to the "range of reasonableness" in making a proportionality determination. [50] If the trial court determines that the defensive devices protecting a merger are not preclusive or coercive, the proportionality paradigm of *Unocal* is applicable. The board must demonstrate that it has reasonable grounds for believing that a danger to the corporation and its stockholders exists if the merger transaction is not consummated. [51] That burden is satisfied "by showing good faith and reasonable investigation." [52] Such proof is materially enhanced if it is approved by a board comprised of a majority of outside directors or by an independent committee. [53]

50 *Id. at 1367.*
51 *Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 955.*
[**50]
52 *Id.* (citation omitted).
53 *Id.* (citations omitted).

When the focus of judicial scrutiny shifts to the range of reasonableness, *Unocal* requires that any defensive devices must be proportionate to the perceived threat to the corporation and its stockholders if the merger transaction is not consummated. Defensive devices taken to protect a merger agreement executed by a board of directors are intended to give that agreement an advantage over any subsequent transactions that materialize before the merger is approved by the stockholders and consummated. This is analogous to the favored treatment that a board of directors may properly give to encourage an initial bidder when it discharges its fiduciary duties under *Revlon*.

[*933] Therefore, in the context of a merger that does not involve a change of control, when defensive devices in the executed merger agreement are challenged *vis-a-vis* their effect on a subsequent competing alternative merger [*934] transaction, this Court's analysis in *Macmillan* is didactic. [54] In the context of a case of defensive measures taken against [**51] an existing bidder, we stated in *Macmillan*:

In the face of disparate treatment, the trial court must first examine whether the directors properly

perceived that shareholder interests were enhanced. In any event the board's action must be reasonable in relation to the advantage sought to be achieved [by the merger it approved], or conversely, to the threat which a [competing transaction] poses to stockholder interests. If on the basis of this enhanced *Unocal* scrutiny the trial court is satisfied that the test has been met, then the directors' actions necessarily are entitled to the protections of the business judgment rule. [55]

54 *Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1288 (Del. 1988).*

55 *Id.* (citation omitted).

The latitude a board will have in either maintaining or using the defensive devices it has adopted to protect the merger it approved will vary according to the degree of benefit or detriment to the stockholders' interests that is presented [**52] by the value or terms of the subsequent competing transaction. [56]

56 *Id.*

Genesis' One Day Ultimatum

The record reflects that two of the four NCS board members, Shaw and Outcalt, were also the *same* two NCS stockholders who combined to control a majority of the stockholder voting power. Genesis gave the four person NCS board less than twenty-four hours to vote in favor of its proposed merger agreement. Genesis insisted the merger agreement include a *Section 251(c)* clause, mandating its submission for a stockholder vote even if the board's recommendation was withdrawn. Genesis further insisted that the merger agreement omit any effective fiduciary out clause.

Genesis also gave the two stockholder members of the NCS board, Shaw and Outcalt, the same accelerated time table to personally sign the proposed voting agreements. These voting agreements committed them irrevocably to vote their majority power in favor of the merger and further provided in Section 6 that the voting agreements be specifically [**53] enforceable. Genesis also required that NCS execute the voting agreements.

Genesis' twenty-four hour ultimatum was that, *unless both* the merger agreement and the voting agreements were signed with the terms it requested, its offer was going to be withdrawn. According to Genesis' attorneys, these "were unalterable conditions to Genesis' willingness to proceed." Genesis insisted on the execution of the interlocking voting rights and merger agreements because it feared that Omnicare would make a superior merger proposal. The NCS board signed the voting rights and merger agreements, without any effective fiduciary out clause, to expressly guarantee that the Genesis merger would be approved, even if a superior merger transaction was presented from Omnicare or any other entity.

Deal Protection Devices

Defensive devices, as that term is used in this opinion, is a synonym for what are frequently referred to as "deal protection devices." Both terms are used interchangeably to describe any measure or combination of measures that are intended to protect the consummation of a merger transaction. Defensive devices can be economic, structural, or both.

Deal protection devices need [**54] not all be in the merger agreement itself. In this case, for example, the *Section 251(c)* provision in the merger agreement was combined with the separate voting agreements to provide a structural defense for the Genesis merger agreement against any subsequent superior transaction. Genesis made the NCS board's defense of its transaction absolute by insisting on the omission of any effective fiduciary out clause in the NCS merger agreement.

Genesis argues that stockholder voting agreements cannot be construed as deal protection devices taken by a board

of directors because stockholders are entitled to vote in their own interest. Genesis cites *Williams v. Geier* [57] and *Stroud v. Grace* [58] for the proposition that voting agreements are not subject to the *Unocal* standard of review. Neither of those cases, however, holds that the operative effect of a voting agreement must be disregarded *per se* when a *Unocal* analysis is applied to a comprehensive and combined merger defense plan.

57 *Williams v. Geier, 671 A.2d 1368 (Del. 1996).*
58 *Stroud v. Grace, 606 A.2d 75 (Del. 1992).*

[**55] In this case, the stockholder voting agreements were inextricably intertwined with the defensive aspects of the Genesis merger agreement. In fact, the voting agreements with Shaw and Outcalt were the linchpin of Genesis' proposed tripartite defense. Therefore, Genesis made the execution of those voting agreements a non-negotiable condition precedent to its execution of the merger agreement. In the case before us, the Court of Chancery held that the acts which locked-up the Genesis transaction were the *Section 251(c)* provision and "the execution of the *voting agreement* by Outcalt and Shaw."

With the assurance that Outcalt and Shaw would irrevocably agree to exercise their majority voting power in favor of its transaction, Genesis insisted that the merger agreement reflect the other two aspects of its concerted defense, i. e., the inclusion of a *Section 251(c)* provision and the omission of any effective fiduciary out clause. Those dual aspects of the merger agreement would not have provided Genesis with a complete defense in the absence of the voting agreements with Shaw and Outcalt.

These Deal Protection Devices Unenforceable

In this case, the Court of Chancery correctly [**56] held that the NCS directors' decision to adopt defensive devices to *completely* "lock up" the Genesis merger mandated "special scrutiny" under the two-part test set forth in *Unocal.* [59] That conclusion is consistent with our holding in *Paramount v. Time* that "safety devices" adopted to protect a transaction that did not result in a change of control are subject to enhanced judicial scrutiny under a *Unocal* analysis. [60] The record does not, however, support the Court of Chancery's conclusion that the defensive devices adopted by the NCS board to protect the Genesis merger were reasonable and proportionate to the threat that NCS perceived from the potential loss of the Genesis transaction.

59 *In re NCS Healthcare, Inc., 2002 Del. Ch. LEXIS 133, 2002 WL 31720732, at *16 (Del. Ch. Nov. 22, 2002). See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).*
60 *See Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1151 (Del. 1989)* (holding that "structural safety devices" in a merger agreement are properly subject to a *Unocal* analysis).

[**57] [*935] Pursuant to the judicial scrutiny required under *Unocal's* two-stage analysis, the NCS directors must first demonstrate "that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed ...." [61] To satisfy that burden, the NCS directors are required to show they acted in good faith after conducting a reasonable investigation. [62] The threat identified by the NCS board was the possibility of losing the Genesis offer and being left with no comparable alternative transaction.

61 *Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)* (citation omitted).
62 *Id.*

The second stage of the *Unocal* test requires the NCS directors to demonstrate that their defensive response was "reasonable in relation to the threat posed." [63] This inquiry involves a two-step analysis. The NCS directors must first establish that the merger deal protection devices adopted in response to the threat were not "coercive" or "preclusive," and then demonstrate [**58] that their response was within a "range of reasonable responses" to the threat perceived. [64] In *Unitrin,* we stated:

-A response is "coercive" if it is aimed at forcing upon

stockholders a management-sponsored alternative to a hostile

offer. [65]

-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. [66]

63 *Id.*
64 *Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387-88 (Del. 1995).*
65 *Id. at 1387*; *Paramount Communications, Inc. v. Time Inc., 571 A.2d at 1154.*
66 *Id.*

This aspect of the *Unocal* standard provides for a disjunctive analysis. If defensive measures are either preclusive or coercive they are draconian and impermissible. In this case, the deal protection devices of the NCS board were *both* preclusive and coercive.

This Court enunciated the standard for [**59] determining stockholder coercion in the case of *Williams v. Geier.* [67] A stockholder vote may be nullified by wrongful coercion "where the board or some other party takes actions which have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction." [68] In *Brazen v. Bell Atlantic Corporation*, we applied that test for stockholder coercion and held "that although the termination fee provision may have influenced the stockholder vote, there were 'no structurally or situationally coercive factors' that made an otherwise valid fee provision impermissibly coercive" under the facts presented. [69]

67 *Williams v. Geier, 671 A.2d 1368 (Del. 1996).*
68 *Id. at 1382-83* (citations omitted).
69 *Brazen v. Bell Atl. Corp., 695 A.2d 43, 50 (Del. 1997).*

In *Brazen*, we concluded "the determination of whether a particular stockholder vote has been robbed of its effectiveness [**60] by impermissible coercion depends on the facts of the case." [70] In this case, the Court of Chancery did not expressly address the issue of "coercion" in its *Unocal* analysis. It did find as a fact, however, that NCS's public stockholders (who owned 80% of NCS and overwhelmingly supported Omnicare's offer) [*936] will be forced to accept the Genesis merger because of the structural defenses approved by the NCS board. Consequently, the record reflects that any stockholder vote would have been robbed of its effectiveness by the impermissible coercion that predetermined the outcome of the merger without regard to the merits of the Genesis transaction at the time the vote was scheduled to be taken. [71] Deal protection devices that result in such coercion cannot withstand *Unocal's* enhanced judicial scrutiny standard of review because they are not within the range of reasonableness.

70 *Brazen v. Bell Atl. Corp., 695 A.2d at 50* (quoting *Williams v. Geier, 671 A.2d at 1383*).
71 *See Brazen v. Bell Atl. Corp., 695 A.2d at 50.*

[**61] 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.* The record reflects that the defensive devices employed by the NCS board are preclusive and coercive in the sense that they accomplished *a fait accompli.* In this case, despite the fact that the NCS board has withdrawn its recommendation for the Genesis transaction and recommended its rejection by the stockholders, the deal protection devices approved by the NCS board operated in concert to have a preclusive and coercive effect. Those tripartite defensive measures -the *Section 251(c)* provision, the voting agreements, and the absence of an effective fiduciary out clause -made it "mathematically impossible" and "realistically unattainable" for the Omnicare transaction or any other proposal to succeed, no matter how superior the proposal. [72]

72 *See Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d at 1388-89*; *see also Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1195 (Del. Ch. 1998)* (citations omitted).

[**62] The deal protection devices adopted by the NCS board were designed to coerce the consummation of the Genesis merger and preclude the consideration of any superior transaction. The NCS directors' defensive devices are not within a reasonable range of responses to the perceived threat of losing the Genesis offer because they are preclusive and coercive. [73] Accordingly, we hold that those deal protection devices are unenforceable.

73 *See Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d at 1389.*

Effective Fiduciary Out Required

The defensive measures that protected the merger transaction are unenforceable not only because they are preclusive and coercive but, alternatively, they are unenforceable because they are invalid as they operate in this case. Given the specifically enforceable irrevocable voting agreements, the provision in the merger agreement requiring the board to submit the transaction for a stockholder vote and the omission of a fiduciary out clause in the merger agreement completely [**63] prevented the board from discharging its fiduciary responsibilities to the minority stockholders when Omnicare presented its superior transaction. "To the extent that a [merger] contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable." [74]

74 *Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 51 (Del. 1993)* (citation omitted). *Restatement (Second) of Contracts § 193* explicitly provides that a "promise by a fiduciary to violate his fiduciary duty *or a promise that tends to induce such a violation is unenforceable on grounds of public policy.*" The comments to that section indicate that "[d] irectors and other officials of a corporation act in a fiduciary capacity and are subject to the rule stated in this Section." *Restatement (Second) of Contracts § 193* (1981) (emphasis added).

[*937] In *QVC*, [75] this Court recognized that "[w] hen a majority of a [**64] corporation's voting shares are acquired by a single person or entity, or by *a cohesive group acting together* [as in this case], there is a significant diminution in the voting power of those who thereby become minority stockholders." [76] Therefore, we acknowledged that "[i] n the absence of devices protecting the minority stockholders, stockholder votes are likely to become mere formalities," where a cohesive group acting together to exercise majority voting powers have already decided the outcome. [77] Consequently, we concluded that since the minority stockholders lost the power to influence corporate direction through the ballot, "minority stockholders must rely for protection solely on the fiduciary duties owed to them by the directors." [78]

75 *Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1993).*
76 *Id. at 42* (emphasis added).
77 *Id.* (footnote omitted).
78 *Id. at 43.*

Under the circumstances presented [**65] in this case, where a cohesive group of stockholders with majority voting power was irrevocably committed to the merger transaction, "[e] ffective representation of the financial interests of the minority shareholders imposed upon the [NCS board] an affirmative responsibility to protect those minority shareholders' interests." [79] The NCS board could not abdicate its fiduciary duties to the minority by leaving it to the stockholders alone to approve or disapprove the merger agreement because two stockholders had already combined to establish a majority of the voting power that made the outcome of the stockholder vote a foregone conclusion.

79 *McMullin v. Beran, 765 A.2d 910, 920 (Del. 2000).*

The Court of Chancery noted that *Section 251(c) of the Delaware General Corporation Law* now permits boards to

agree to submit a merger agreement for a stockholder vote, even if the Board later withdraws its support for that agreement and recommends that the stockholders reject it. [80] The Court of [**66] Chancery also noted that stockholder voting agreements are permitted by Delaware law. In refusing to certify this interlocutory appeal, the Court of Chancery stated "it is simply nonsensical to say that a board of directors abdicates its duties to manage the 'business and affairs' of a corporation under *Section 141(a) of the DGCL* by agreeing to the inclusion in a merger agreement of a term authorized by *§ 251(c)* of the same statute."

80 *Section 251(c)* was amended in 1998 to allow for the inclusion in a merger agreement of a term requiring that the agreement be put to a vote of stockholders whether or not their directors continue to recommend the transaction. Before this amendment, *Section 251* was interpreted as precluding a stockholder vote if the board of directors, after approving the merger agreement but before the stockholder vote, decided no longer to recommend it. *See Smith v. Van Gorkom, 488 A.2d 858, 887-88 (Del. 1985).*

Taking action that is otherwise legally possible, however, does [**67] not *ipso facto* comport with the fiduciary responsibilities of directors in all circumstances. [81] The synopsis to the amendments that resulted in the enactment of *Section 251(c)* in the Delaware corporation law statute specifically provides: "the amendments are not intended to address the question of whether such a submission requirement is appropriate in any particular set of factual circumstances." *Section 251* provisions, like the no-shop provision examined in QVC, [*938] are "presumptively valid in the abstract." [82] Such provisions in a merger agreement may not, however, "validly define or limit the directors' fiduciary duties under Delaware law or prevent the [NCS] directors from carrying out their fiduciary duties under Delaware law." [83]

81 *MM Companies v. Liquid Audio, Inc., 813 A.2d 1118, 1132 (Del. 2003)* (citation omitted).
82 *Paramount Communications Inc. v. QVC Network Inc., 637 A.2d at 48.*
83 *Id.*

Genesis admits that when the NCS board agreed to [**68] its merger conditions, the NCS board was seeking to assure that the NCS creditors were paid in full and that the NCS stockholders received the highest value available for their stock. In fact, Genesis defends its "bulletproof" merger agreement on that basis. We hold that the NCS board did not have authority to accede to the Genesis demand for an absolute "lock-up."

The directors of a Delaware corporation have a continuing obligation to discharge their fiduciary responsibilities, as future circumstances develop, after a merger agreement is announced. Genesis anticipated the likelihood of a superior offer after its merger agreement was announced and demanded defensive measures from the NCS board that *completely* protected its transaction. [84] Instead of agreeing to the absolute defense of the Genesis merger from a superior offer, however, the NCS board was required to negotiate a fiduciary out clause to protect the NCS stockholders if the Genesis transaction became an inferior offer. By acceding to Genesis' ultimatum for complete protection *in futuro*, the NCS board disabled itself from exercising its own fiduciary obligations at a time when the board's own judgment is most important, [**69] [85] i. e. receipt of a subsequent superior offer.

84 The marked improvements in NCS's financial situation during the negotiations with Genesis strongly suggests that the NCS board should have been alert to the prospect of competing offers or, as eventually occurred, a bidding contest.
85 *See Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998)* (directors' fiduciary duties do not operate intermittently). *See also Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985).*

Any board has authority to give the proponent of a recommended merger agreement reasonable structural and economic defenses, incentives, and fair compensation if the transaction is not completed. To the extent that defensive measures are economic and reasonable, they may become an increased cost to the proponent of any subsequent transaction. Just as defensive measures cannot be draconian, however, they cannot limit or circumscribe the directors' fiduciary duties. Notwithstanding the corporation's insolvent [**70] condition, the NCS board had no authority to

execute a merger agreement that subsequently prevented it from effectively discharging its ongoing fiduciary responsibilities.

The stockholders of a Delaware corporation are entitled to rely upon the board to discharge its fiduciary duties at all times. [86] The fiduciary duties of a director are unremitting and must be effectively discharged in the specific context of the actions that are required with regard to the corporation or its stockholders as circumstances change. [87] The stockholders with majority voting power, Shaw and Outcalt, had an absolute right to sell or exchange their shares with a third party at any price. This right was not only known to the other directors of NCS, it became an integral part of the Genesis agreement. In its answering brief, Genesis candidly [*939] states that its offer "came with a condition -Genesis would not be a stalking horse and would not agree to a transaction to which NCS's controlling shareholders were not committed."

86 *Malone v. Brincat, 722 A.2d at 10.*

87 *Id.; Moran v. Household Int'l, Inc., 500 A.2d at 1357* (use of defense evaluated if and when the issue arises).

[**71] The NCS board was required to contract for an effective fiduciary out clause to exercise its continuing fiduciary responsibilities to the minority stockholders. [88] The issues in this appeal do not involve the general validity of either stockholder voting agreements or the authority of directors to insert a *Section 251(c)* provision in a merger agreement. In this case, the NCS board combined those two otherwise valid actions and caused them to operate in concert as an absolute lock up, in the absence of an effective fiduciary out clause in the Genesis merger agreement.

88 *See Paramount Communications Inc. v. QVC Network Inc., 637 A.2d at 42-43.* Merger agreements involve an ownership decision and, therefore, cannot become final without stockholder approval. Other contracts do not require a fiduciary out clause because they involve business judgments that are within the *exclusive* province of the board of directors' power to manage the affairs of the corporation. *See Grimes v. Donald, 673 A.2d 1207, 1214-15 (Del. 1996).*

[**72] In the context of this preclusive and coercive lock up case, the protection of Genesis' contractual expectations must yield to the supervening responsibility of the directors to discharge their fiduciary duties on a continuing basis. The merger agreement and voting agreements, as they were combined to operate in concert in this case, are inconsistent with the NCS directors' fiduciary duties. To that extent, we hold that they are invalid and unenforceable. [89]

Conclusion

89 *Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d at 51.*

With respect to the Fiduciary Duty Decision, the order of the Court of Chancery dated November 22, 2002, denying plaintiffs' application for a preliminary injunction is reversed. With respect to the Voting Agreements Decision, the order of the Court of Chancery dated October 29, 2002 is reversed to the extent that decision permits the implementation of the Voting Agreements contrary to this Court's ruling on the Fiduciary Duty claims. With [**73] respect to the appeal to this Court of that portion of the Standing Decision constituting the order of the Court of Chancery dated October 25, 2002, that granted the motion to dismiss the remainder of the Omnicare complaint, holding that Omnicare lacked standing to assert fiduciary duty claims arising out of the action of the board of directors that preceded the date on which Omnicare acquired its stock, the appeal is dismissed as moot.

The mandate shall issue immediately.

DISSENT BY: VEASEYSteele

DISSENT

VEASEY, Chief Justice, with whom **STEELE**, Justice, joins dissenting:

The beauty of the Delaware corporation law, and the reason it has worked so well for stockholders, directors and officers, is that the framework is based on an enabling statute with the Court of Chancery and the Supreme Court applying principles of fiduciary duty in a common law mode on a case-by-case basis. Fiduciary duty cases are inherently fact-intensive and, therefore, unique. This case is unique in two important respects. First, the peculiar facts presented render this case an unlikely candidate for substantial repetition. Second, this is a rare 3-2 split decision of the Supreme Court. [90]

90 Split decisions by this Court, especially in the field of corporation law, are few and far between. One example is our decision in *Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)*, where only three Justices supported reversing the Court of Chancery's decision. As Justice Holland and David Skeel recently noted, while our decisionmaking process fosters consensus, dissenting opinions "illustrate that principled differences of opinion about the law [are] ...never compromised for the sake of unanimity." Randy J. Holland & David A. Skeel, Jr., *Deciding Cases Without Controversy, 5 Del. L. Rev. 115, 118 (2002).*

[**74] [*940] In the present case, we are faced with a merger agreement and controlling stockholders' commitment that assured stockholder approval of the merger before the emergence of a subsequent transaction offering greater value to the stockholders. This does not adequately summarize the unique facts before us, however. Reference is made to the Vice Chancellor's pinion and the factual summary in the Majority Opinion that adopts the Vice Chancellor's findings. [91]

91 *Majority Opinion* at 11-30.

The process by which this merger agreement came about involved a joint decision by the controlling stockholders and the board of directors to secure what appeared to be the only value-enhancing transaction available for a company on the brink of bankruptcy. The Majority adopts a new rule of law that imposes a prohibition on the NCS board's ability to act in concert with controlling stockholders to lock up this merger. The Majority reaches this conclusion by analyzing the challenged deal protection measures as isolated board [**75] actions. The Majority concludes that the board owed a duty to the NCS minority stockholders to refrain from acceding to the Genesis demand for an irrevocable lock-up notwithstanding the compelling circumstances confronting the board and the board's disinterested, informed, good faith exercise of its business judgment.

Because we believe this Court must respect the reasoned judgment of the board of directors and give effect to the wishes of the controlling stockholders, we respectfully disagree with the Majority's reasoning that results in a holding that the confluence of board and stockholder action constitutes a breach of fiduciary duty. The essential fact that must always be remembered is that this agreement and the voting commitments of Outcalt and Shaw concluded a lengthy search and intense negotiation process in the context of insolvency and creditor pressure where no other viable bid had emerged. Accordingly, we endorse the Vice Chancellor's well-reasoned analysis that the NCS board's action before the hostile bid emerged was within the bounds of its fiduciary duties under these facts.

We share with the Majority and the independent NCS board of directors the motivation to serve [**76] carefully and in good faith the best interests of the corporate enterprise and, thereby, the stockholders of NCS. It is now known, of course, after the case is over, that the stockholders of NCS will receive substantially more by tendering their shares into the topping bid of Omnicare than they would have received in the Genesis merger, as a result of the post-agreement Omnicare bid and the injunctive relief ordered by the Majority of this Court. Our jurisprudence cannot, however, be seen as turning on such ex post felicitous results. Rather, the NCS board's good faith decision must be subject to a real-time review of the board action before the NCS-Genesis merger agreement was entered into.

An Analysis of the Process Leading to the Lock-up Reflects a Quintessential, Disinterested and Informed Board Decision Reached in Good Faith

The Majority has adopted the Vice Chancellor's findings and has assumed arguendo that the NCS board fulfilled its duties of care, loyalty, and good faith by entering into the Genesis merger agreement. Indeed, this conclusion is indisputable [*941] on this record. The problem is that the Majority has removed from their proper context the contractual [**77] merger protection provisions. The lock-ups here cannot be reviewed in a vacuum. A court should review the entire bidding process to determine whether the independent board's actions permitted the directors to inform themselves of their available options and whether they acted in good faith. [92]

92 *See, e. g., Malpiede v. Townson, 780 A.2d 1075, 1089 (Del. 2001)* (concluding that the board made an informed decision to refrain from returning to a rival bidder to solicit another offer because the board conducted a "lengthy sale process" that spanned one year).

Going into negotiations with Genesis, the NCS directors knew that, up until that time, NCS had found only one potential bidder, Omnicare. Omnicare had refused to buy NCS except at a fire sale price through an asset sale in bankruptcy. Omnicare's best proposal at that stage would not have paid off all creditors and would have provided nothing for stockholders. The Noteholders, represented by the Ad Hoc Committee, were willing to oblige Omnicare [**78] and force NCS into bankruptcy if Omnicare would pay in full the NCS debt. Through the NCS board's efforts, Genesis expressed interest that became increasingly attractive. Negotiations with Genesis led to an offer paying creditors off and conferring on NCS stockholders $ 24 million- an amount infinitely superior to the prior Omnicare proposals.

But there was, understandably, a sine qua non. In exchange for offering the NCS stockholders a return on their equity and creditor payment, Genesis demanded certainty that the merger would close. If the NCS board would not have acceded to the *Section 251(c)* provision, if Outcalt and Shaw had not agreed to the voting agreements and if NCS had insisted on a fiduciary out, there would have been no Genesis deal! Thus, the only value-enhancing transaction available would have disappeared. NCS knew that Omnicare had spoiled a Genesis acquisition in the past, [93] and it is not disputed by the Majority that the NCS directors made a reasoned decision to accept as real the Genesis threat to walk away. [94]

93 *Majority Opinion* at 19.

94 In *Citron v. Fairchild Camera & Instrument Corp.*, we noted that "whether the constraints are self-imposed or attributable to bargaining tactics of an adversary seeking a final resolution of a belabored process must be considered" in analyzing the target's decision to accept an ultimatum from a bidder. *569 A.2d 53, 67 (Del. 1989).* Based on Genesis's prior dealings with Omnicare, NCS had good reason to take the Genesis ultimatum seriously.

[**79] When Omnicare submitted its conditional eleventh-hour bid, the NCS board had to weigh the economic terms of the proposal against the uncertainty of completing a deal with Omnicare. [95] Importantly, because Omnicare's bid was conditioned on its satisfactorily completing its due diligence review of NCS, the NCS board saw this as a crippling condition, as did the Ad Hoc Committee. As a matter of business judgment, the risk of negotiating with Omnicare and losing Genesis at that point outweighed the possible benefits. [96] The [*942] lock-up was indisputably a sine qua non to any deal with Genesis.

95 *See Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1282 n. 29* ("In assessing the bid and the bidder's responsibility, a board may consider, among various proper factors ...the risk of nonconsummation. ..."); *Citron, 569 A.2d 53 at 68-69* ("We will not hold a target board of predominantly disinterested directors liable for allegedly failing to exhibit due care when the bidder does not provide the target board with a definitive bid.").

96 *See RJR Nabisco, Inc. S'holders Litig.*, 1989 WL 7036 at *19 (Del. Ch.). In *RJR*, the Court of Chancery held that the RJR Nabisco board could justifiably accept the highest bid it received from one bidder, KKR, rather than inquire about a higher offer from the other suitor, the management group, because KKR might have withdrawn its bid. *Id.* at *19.

[**80] A lock-up permits a target board and a bidder to "exchange certainties." [97] Certainty itself has value. The

acquirer may pay a higher price for the target if the acquirer is assured consummation of the transaction. The target company also benefits from the certainty of completing a transaction with a bidder because losing an acquirer creates the perception that a target is damaged goods, thus reducing its value.

97 *See Rand v. Western Air Lines*, 1994 Del. Ch. LEXIS 26, 1994 WL 89006 at *6 (Del. Ch.).

This Court approved the recognition by the Court of Chancery of the value of certainty in *Rand v. Western Air Lines*. [98] The Court of Chancery upheld the decision of the board of Western Air Lines to grant its only bidder a stock option agreement to acquire 30% of Western's stock for an amount representing the closing price on the last trading day before execution of the merger agreement. [99] The Court recognized that the lock-up agreement "foreclosed further bidding," but noted that the board had canvassed the [**81] market, found only one party willing to acquire Western, and made a decision calculated to maximize stockholder value by pursuing "the only viable prospect that remained." [100] The Court also noted that, in return for the lock-up, the acquirer agreed to limit its own "outs" that would prevent consummation of the merger. The merging parties, then, "exchanged certainties" by locking up the deal, which was approved by the Court of Chancery and affirmed by this Court. [101]

98 1994 Del. Ch. LEXIS 26, 1994 WL 89006 (Del. Ch.) *aff'd 659 A.2d 228 (Del. 1995)*.
99 Rand, 1994 Del. Ch. LEXIS 26.
100 Rand, 1994 Del Ch. LEXIS 26.
101 Rand, 1994 Del Ch. LEXIS 26 ("Western gained a substantial benefit for its stockholders by keeping the only party expressing any interest at the table while achieving its own assurances that the transaction would be consummated.").

While the present case does not involve an attempt to hold on to only one interested bidder, the NCS board was equally concerned about "exchanging certainties" with Genesis. If [**82] the creditors decided to force NCS into bankruptcy, which could have happened at any time as NCS was unable to service its obligations, the stockholders would have received nothing. The NCS board also did not know if the NCS business prospects would have declined again, leaving NCS less attractive to other bidders, including Omnicare, which could have changed its mind and again insisted on an asset sale in bankruptcy.

Situations will arise where business realities demand a lock-up so that wealth-enhancing transactions may go forward. Accordingly, any bright-line rule prohibiting lock-ups could, in circumstances such as these, chill otherwise permissible conduct.

Our Jurisprudence Does Not Compel This Court to Invalidate the Joint Action of the Board and the Controlling Stockholders

The Majority invalidates the NCS board's action by announcing a new rule that represents an extension of our jurisprudence. That new rule can be narrowly stated as follows: A merger agreement entered into after a market search, before any prospect of a topping bid has emerged, which locks up stockholder approval and does not contain a "fiduciary out" provision, is per se invalid when a later [**83] significant topping bid emerges. As we have noted, this bright-line, per se rule would apply regardless of (1) the circumstances leading up to the agreement and (2) the fact that stockholders who control voting [*943] power had irrevocably committed themselves, *as stockholders*, to vote for the merger. Narrowly stated, this new rule is a judicially-created "third rail" that now becomes one of the given "rules of the game," to be taken into account by the negotiators and drafters of merger agreements. In our view, this new rule is an unwise extension of existing precedent.

Although it is debatable whether *Unocal* applies- and we believe that the better rule in this situation is that the business judgment rule should apply [102] -we will, nevertheless, assume arguendo- as the Vice Chancellor did- that *Unocal* applies. Therefore, under *Unocal* the NCS directors had the burden of going forward with the evidence to show that there was a threat to corporate policy and effectiveness and that their actions were reasonable in response to that

threat. The Vice Chancellor correctly found that they reasonably perceived the threat that NCS did not have a viable offer from Omnicare- or anyone [**84] else- to pay off its creditors, cure its insolvency and provide some payment to stockholders. The NCS board's actions- as the Vice Chancellor correctly held- were reasonable in relation to the threat because the Genesis deal was the "only game in town," the NCS directors got the best deal they could from Genesis and- but-for the emergence of Genesis on the scene- there would have been no viable deal.

102 The basis for the *Unocal* doctrine is the "omnipresent specter" of the board's self-interest to entrench itself in office. *Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).* NCS was not plagued with a specter of self-interest. Unlike the *Unocal* situation, a hostile offer did not arise here until *after* the market search and the locked-up deal with Genesis. The *Unocal* doctrine applies to unilateral board actions that are defensive and reactive in nature. Thus, a *Unocal* analysis was necessary in *Paramount Communications v. Time Inc.* because Time and Warner restructured their original transaction from a merger to an acquisition *in response* to the Paramount bid. *571 A.2d 1140, 1148 (Del. 1989).* In *Time*, the original Time-Warner stock-for-stock merger, which this Court held was entitled to the presumption of the business judgment rule, was jettisoned by the parties in the face of Paramount's topping bid. *Id. at 1152.* The merger was replaced with a new transaction which was an all cash tender offer by Time to acquire 51 of the Warner stock. It was the revised agreement, not the original merger agreement, that was found to be "defense-motivated" and subject to *Unocal. Id.*

[**85] The Vice Chancellor held that the NCS directors satisfied *Unocal*. He even held that they would have satisfied *Revlon*, if it had applied, which it did not. Indeed, he concluded- based on the undisputed record and his considerable experience- that: "The overall quality of testimony given by the NCS directors is among the strongest this court has ever seen. All four NCS directors were deposed, and each deposition makes manifest the care and attention given to this project by every member of the board." [103] We agree fully with the Vice Chancellor's findings and conclusions, and we would have affirmed the judgment of the Court of Chancery on that basis.

103 *In re NCS Healthcare, Inc. S'holders Litig., 2002 Del. Ch. LEXIS 133, 2002 WL 31720732 (Del. Ch.)* ("Chancery, *Fiduciary Duty Opinion*") at *15 n. 46.

In our view, the Majority misapplies the *Unitrin* concept of "coercive and preclusive" measures to preempt a proper proportionality balancing. Thus, the Majority asserts that "in applying *enhanced judicial* [**86] *scrutiny* to *defensive devices* designed to protect a merger agreement, ...a court must. ..determine that those measures are not preclusive or coercive. ..." [104] Here, the deal protection measures were not adopted unilaterally by the board to fend off an existing hostile offer that [*944] threatened the corporate policy and effectiveness of NCS. [105] They were adopted because Genesis- the "only game in town"- would not save NCS, its creditors and its stockholders without these provisions.

104 *Majority Opinion* at 42 (emphasis supplied.).
105 The Majority states that our decisions in *Williams v. Geier* and *Stroud v. Grace* do not hold that "the operative effect of a voting agreement must be disregarded *per se* when a *Unocal* analysis is applied to a comprehensive and combined merger defense plan." *Majority Opinion* at 46. In *Stroud v. Grace*, however, we noted that "The record clearly indicates, and [plaintiff] ...concedes, that over 50 of the outstanding shares of ...[the corporation] are under the direct control of [the defendants]. ...These directors controlled the corporation in fact and law. *This obviates any threat contemplated by Unocal. ..." 606 A.2d 75, 83 (Del. 1992)* (emphasis supplied). According to *Stroud*, then, Shaw's and Outcalt's decision to enter into the voting agreements should not be subject to a *Unocal* analysis because they controlled the corporation "in fact and law." *Id.* Far from a breach of duty, the joint action of the stockholders and directors here represents "the highest and best form of corporate democracy." *Williams v. Geier, 671 A.2d 1368, 1381 (Del. 1996).*

[**87] The Majority- incorrectly, in our view- relies on *Unitrin* to advance its analysis. The discussion of "draconian" measures in *Unitrin* dealt with unilateral board action, a repurchase program, designed to fend off an existing hostile offer by American General. [106] In *Unitrin* we recognized the need to police preclusive and coercive

actions initiated *by the board* to delay or retard an existing hostile bid so as to ensure that the stockholders can benefit from the board's negotiations with the bidder or others and to exercise effectively the franchise as the ultimate check on board action. [107] *Unitrin* polices the effect of board action on existing tender offers and proxy contests to ensure that the board cannot permanently impose its will on the stockholders, leaving the stockholders no recourse to their voting rights. [108]

106 *Unitrin, Inc. v. American General Corp., 651 A.2d 1361, 1370 (Del. 1995).*

107 *Id. at 1379* ("We begin our examination of Unitrin's Repurchase Program mindful of the special import of protecting the shareholder's franchise within *Unocal's* requirement that a defensive measure be reasonable and proportionate.") (citation omitted).

[**88]

108 *Id. at 1383* (upholding the Unitrin board's defensive measures because the board actions "would not appear to have a preclusive effect upon American General's ability successfully to marshal enough shareholder votes to win a proxy contest.").

The very measures the Majority cites as "coercive" were approved by Shaw and Outcalt through the lens of their independent assessment of the merits of the transaction. The proper inquiry in this case is whether the NCS board had taken actions that "have the effect of causing the stockholders to vote in favor of the proposed transaction for some reason other than the merits of that transaction." [109] Like the termination fee upheld as a valid liquidated damages clause against a claim of coercion in *Brazen v. Bell Atlantic Corp.*, the deal protection measures at issue here were "an integral part of the merits of the transaction" as the NCS board struggled to secure- and did secure- the only deal available. [110]

109 *Geier, 671 A.2d at 1382-83* (citations omitted).

[**89]

110 *695 A.2d 43, 50 (Del. 1997).*

Outcalt and Shaw were fully informed stockholders. As the NCS controlling stockholders, they made an informed choice to commit their voting power to the merger. The [*945] minority stockholders were deemed to know that when controlling stockholders have 65% of the vote they can approve a merger without the need for the minority votes. Moreover, to the extent a minority stockholder may have felt "coerced" to vote for the merger, which was already a *fait accompli*, it was a meaningless coercion- or no coercion at all- because the controlling votes, those of Outcalt and Shaw, were already "cast." Although the fact that the controlling votes were committed to the merger "precluded" an overriding vote against the merger by the Class A stockholders, the pejorative "preclusive" label applicable in a *Unitrin* fact situation has no application here. Therefore, there was no meaningful minority stockholder voting decision to coerce.

In applying *Unocal* scrutiny, we believe the Majority incorrectly preempted the proportionality inquiry. In our view, the [**90] proportionality inquiry must account for the reality that the contractual measures protecting this merger agreement were necessary to obtain the Genesis deal. The Majority has not demonstrated that the director action was a disproportionate response to the threat posed. Indeed, it is clear to us that the board action to negotiate the best deal reasonably available with the only viable merger partner (Genesis) who could satisfy the creditors and benefit the stockholders, was reasonable in relation to the threat, by any practical yardstick.

An Absolute Lock-up is Not a Per Se Violation of Fiduciary Duty

We respectfully disagree with the Majority's conclusion that the NCS board breached its fiduciary duties to the Class A stockholders by failing to negotiate a "fiduciary out" in the Genesis merger agreement. What is the practical import of a "fiduciary out?" It is a contractual provision, articulated in a manner to be negotiated, that would permit the board of the corporation being acquired to exit without breaching the merger agreement in the event of a superior offer.

In this case, Genesis made it abundantly clear early on that it was willing to negotiate a deal with NCS [**91] but only on the condition that it would not be a "stalking horse." Thus, it wanted to be certain that a third party could not use its deal with NCS as a floor against which to begin a bidding war. As a result of this negotiating position, a "fiduciary out" was not acceptable to Genesis. The Majority Opinion holds that such a negotiating position, if implemented in the agreement, is invalid per se where there is an absolute lock-up. We know of no authority in our jurisprudence supporting this new rule, and we believe it is unwise and unwarranted.

The Majority relies on our decision in *QVC* to assert that the board's fiduciary duties prevent the directors from negotiating a merger agreement without providing an escape provision. Reliance on *QVC* for this proposition, however, confuses our statement of a board's responsibilities when the directors confront a superior transaction and turn away from it to lock up a less valuable deal with the very different situation here, where the board committed itself to the *only* value-enhancing transaction available. The decision in *QVC* is an extension of prior decisions in *Revlon* and *Mills* that prevent a board from ignoring [**92] a bidder who is willing to match and exceed the favored bidder's offer. [111] The Majority's application of "continuing fiduciary duties" here is a further extension of this concept and thus permits, wrongly in our view, a court to second-guess the risk and return analysis the board must make to weigh the value of the only viable transaction against the prospect of an offer that has not materialized.

111 *Paramount Communications v. QVC Network, 637 A.2d 34, 49-50 (Del. 1993).*

The Majority also mistakenly relies on our decision in *QVC* to support the notion that the NCS board should have retained a fiduciary out to save the minority stockholder [*946] from Shaw's and Outcalt's voting agreements. Our reasoning in *QVC*, which recognizes that minority stockholders must rely for protection on the fiduciary duties owed to them by directors, [112] does not create a *special* duty to protect the minority stockholders from the consequences of a controlling stockholder's ultimate decision unless the [**93] controlling stockholder stands on both sides of the transaction, [113] which is certainly not the case here. Indeed, the discussion of a minority stockholders' lack of voting power in *QVC* notes the importance of enhanced scrutiny in change of control transactions *precisely because* the minority stockholders' interest in the *newly merged entity* thereafter will hinge on the course set by the controlling stockholder. [114] In *QVC*, Sumner Redstone owned 85% of the voting stock of Viacom, the surviving corporation. [115] Unlike the stockholders who are confronted with a transaction that will relegate them to a minority status in the corporation, the Class A stockholders of NCS purchased stock knowing that the Charter provided Class B stockholders voting control.

112 *637 A.2d at 47.*

113 *See Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987)* (noting that absent fiduciary duties arising from standing on both sides of a transaction, "stockholders in Delaware corporations have a right to control and vote their shares in their own interest.").

[**94]

114 *QVC, 637 A.2d at 47-48.*

115 *Id. at 38.*

Conclusion

It is regrettable that the Court is split in this important case. One hopes that the Majority rule announced here- though clearly erroneous in our view- will be interpreted narrowly and will be seen as *sui generis*. [116] By deterring bidders from engaging in negotiations like those present here and requiring that there must always be a fiduciary out, the universe of potential bidders who could reasonably be expected to benefit stockholders could shrink or disappear. Nevertheless, if the holding is confined to these unique facts, negotiators may be able to navigate around this new hazard.

116 Importantly, we decide only the case before us. *QVC, 637 A.2d at 51.*

Accordingly, we respectfully dissent.

STEELE, Justice, dissenting:

I respectfully dissent from the majority opinion, join the [**95] Chief Justice's dissent in all respects and dissent separately in order to crystallize the central focus of my objection to the majority view.

I would affirm the Vice Chancellor's holding denying injunctive relief.

Here the board of directors acted selflessly pursuant to a careful, fair process and determined in good faith that the benefits to the stockholders and corporation flowing from a merger agreement containing reasonable deal protection provisions outweigh any speculative benefits that might result from entertaining a putative higher offer. A court asked to examine the decisionmaking process of the board should decline to interfere with the consummation and execution of an otherwise valid contract.

In my view, the Vice Chancellor's unimpeachable factual findings preclude further judicial scrutiny of the NCS board's business judgment that the hotly negotiated terms of its merger agreement were necessary in order to save the company from financial collapse, repay creditors and provide some benefits to NCS stockholders.

A concurring dissent is not a useful mechanism for restating the facts the Vice Chancellor found significant, particularly [*947] when the majority accepts those [**96] facts and a highly persuasive, compelling dissent, places them squarely in the correct perspective. What is far less clear to me is how the majority can adopt those facts and then conclude that the NCS board breached any fiduciary duty to NCS' minority stockholders simply by endorsing a voting agreement between the majority stockholders that locked up a carefully negotiated and essential merger agreement with Genesis.

In my opinion, Delaware law mandates deference under the business judgment rule to a board of directors' decision that is free from self interest, made with due care and in good faith.

> Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in *§ 141(a)*, that the business and affairs of a Delaware corporation are managed by or under its board of directors. ...The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors. [117]

117 *Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).*

[**97] Importantly, *Smith v. Van Gorkom*, correctly casts the focus on any court review of board action challenged for alleged breach of the fiduciary duty of care "only upon the basis of the information then reasonably available to the directors and relevant to their decision... ." [118] Though criticized particularly for the imposition of personal liability on directors for a breach of the duty of care, *Van Gorkom* still stands for the importance of recognizing the limited circumstances for court intervention and the importance of focusing on the timing of the decision attacked.

118 *Id. at 874*; see *also* R. Franklin Balotti and A. Gilchrist Sparks, III, *Deal-Protection Measures and the Merger Recommendation, 96 Nw. U.L. Rev. 467 (2002)* (an article presaging the conflict between appropriate discharge of fiduciary duty and the sanctity of contract provisions fairly negotiated).

The majority concludes that *Unocal's* intermediate standard of review compels judicial interference [**98] to determine whether contract terms, that the majority refers to at various times as "deal protection devices," "defensive devices," "defensive measures" or "structural safety devices," are preclusive and coercive. The majority's conclusion substantially departs from both a common sense appraisal of the contextual landscape of this case and Delaware case

law applying the *Unocal* standard.

In the factual context of this case, the NCS board had thoroughly canvassed the market in an attempt to find an acquirer, save the company, repay creditors and provide some financial benefit to stockholders. They did so in the face of silence, tepid interest to outright hostility from Omnicare. The only *bona fide*, credible merger partner NCS could find during an exhaustive process was Genesis, a company that had experienced less than desirable relations with Omnicare in the past. Small wonder NCS' only viable merger partner made demands *and concessions* to acquire contract terms that enhanced assurance that the merger would close. The NCS board agreed to lock up the merger with contractual protection provisions in order to avoid the prospect of Genesis walking away from the deal leaving [**99] NCS in the woefully undesirable position of negotiating with a company that had worked for months against NCS' interests by negotiating with NCS' creditors. Those negotiations suggested no regard for NCS' stockholders' interests, and held out only the hope of structuring a purchase of NCS in a bankruptcy environment.

[*948] The contract terms that NCS' board agreed to included no insidious, camouflaged side deals for the directors or the majority stockholders nor transparent provisions for entrenchment or control premiums. At the time the NCS board and the majority stockholders agreed to a voting lockup, the terms were the best reasonably available for all the stockholders, balanced against a genuine risk of no deal at all. The cost benefit analysis entered into by an independent committee of the board, approved by the full board and independently agreed to by the majority stockholders cannot be second guessed by courts with no business expertise that would qualify them to substitute their judgment for that of a careful, selfless board or for majority stockholders who had the most significant economic stake in the outcome.

We should not encourage proscriptive rules that invalidate or render [**100] unenforceable precommitment strategies negotiated between two parties to a contract who will presumably, in the absence of conflicted interest, bargain intensely over every meaningful provision of a contract after a careful cost benefit analysis. Where could this plain common sense approach be more wisely invoked than where a board, free of conflict, fully informed, supported by the equally conflict-free holders of the largest economic interest in the transaction, reaches the conclusion that a voting lockup strategy is the best course to obtain the most benefit for all stockholders?

This fundamental principle of Delaware law so eloquently put in the Chief Justice's dissent, is particularly applicable here where the NCS board had no alternative if the company were to be saved. If attorneys counseling well motivated, careful, and well-advised boards cannot be assured that their clients' decision -sound at the time but later less economically beneficial only because of post-decision, unforeseeable events -will be respected by the courts, Delaware law, and the courts that expound it, may well be questioned. I would not shame the NCS board, which acted in accordance with every fine instinct [**101] that we wish to encourage, by invalidating their action approving the Genesis merger because they failed to insist upon a fiduciary out. I use "shame" here because the majority finds no breach of loyalty or care but nonetheless sanctions these directors for their failure to insist upon a fiduciary out as if those directors had no regard for the effect of their otherwise disinterested, careful decision on others. [119] The majority seeks to deter future boards from similar conduct by declaring that agreements negotiated under similar circumstances will be unenforceable.

119 For a more expansive and thoughtful explanation of the concept of "shaming" in the context of corporate law, *see* David A. Skeel, Jr., *Symposium Norms & Corporate Law: Shaming in Corporate Law, 149 U. Pa. L. Rev. 1811 (2001).*

Delaware corporate citizens now face the prospect that in *every* circumstance, boards must obtain the highest price, even if that requires breaching a contract entered into at a time when no [**102] one could have reasonably foreseen a truly "Superior Proposal." The majority's proscriptive rule limits the scope of a board's cost benefit analysis by taking the bargaining chip of foregoing a fiduciary out "off the table" in all circumstances. For that new principle to arise from the context of this case, when Omnicare, after striving to buy NCS on the cheap by buying off its creditors, slinked back into the fray, reversed its historic antagonistic strategy and offered a conditional "Superior Proposal" seems entirely

counterintuitive.

The majority declares that a fairly negotiated exchange of consideration is invalid and unenforceable on the theory that its [*949] terms preclude minority stockholders from accepting a superior alternative or that it coerces them into accepting an inferior deal while presupposing that the objectionable terms of NCS' agreement with Genesis are "defensive measures." 120 The majority equates those contract provisions with measures affirmatively adopted to prevent a third party bidder from frustrating a deal with an acquirer with which management may choose to deal without being fully informed or for their own self interest. In effect, the majority has adopted [**103] the "duck" theory of contract interpretation. In my view, just as all ducks have their season and the wary hunter carefully scans the air to determine which duck may and which may not be shot at a given time on a certain day, the same holds true for distinguishing between contract provisions that could in another context be deemed truly defensive measures demanding enhanced scrutiny by a court. When certain, or when in doubt that the "duck" is not in season, courts, like prudent waterfowlers, should defer.

120 The majority refers to "defensive measures," "deal protection devices," "structural safety devices" and "defensive devices" as interchangeable, each demanding heightened scrutiny. "Of course, the mere fact that the court calls a 'duck' a 'duck' does not mean that such defense provisions will not be upheld so long as they are not draconian." *McMillan v. Intercargo, 768 A.2d 492, 506 n. 62 (Del. Ch. 2000).*

I believe that the absence of a suggestion of self-interest or lack of care compels [**104] a court to defer to what is a business judgment that a court is not qualified to second guess. However, I recognize that another judge might prefer to view the reasonableness of the board's action through the *Unocal* prism before deferring. 121 Some flexible, readily discernable standard of review must be applied no matter what it may be called. Here, one deferring or one applying *Unocal* scrutiny would reach the same conclusion. When a board agrees rationally, in good faith, without conflict and with reasonable care to include provisions in a contract to preserve a deal in the absence of a better one, their business judgment should not be second-guessed in order to invalidate or declare unenforceable an otherwise valid merger agreement. The fact that majority stockholders free of conflicts have a choice and every incentive to get the best available deal and then make a rational judgment to do so as well neither unfairly impinges upon minority shareholder choice or the concept of a shareholder "democracy" nor has it any independent significance bearing on the reasonableness of the board's separate and distinct exercise of judgment.

121 There appears to be ample enough academic debate over the effectiveness and utility of the analytical tool which should be employed. I do recognize that critics view the business judgment rule as no framework for analysis at all. That view presupposes that judges or regulators have an equal or greater expertise in exercising business judgments as in imposing social policy.

[**105] I cannot follow the majority's reliance on *Paramount v. QVC.* 122 and *Paramount Communications v. Time.* 123 *QVC*, is controlled by the facts of the underlying transaction. The Paramount board did not canvass the market, negotiated exclusively with Viacom despite QVC's announced interest and refused to give QVC an opportunity to top the Viacom offer. Arguably, the Paramount board shunned QVC's higher offer and then turned to lock up a deal with Viacom less valuable to stockholders along with an unreasonable grant of a right to exercise a stock option of unlimited [*950] value. *QVC* does not, in my view, support a policy of decrying and then proscribing precommitment strategies generally on the supposition that in every fact situation they "disable" a board from an efficient breach.

122 *Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1993).*
123 *Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).*

Paramount v. Time [**106] discussed the "original" and the "revised" Time-Warner agreements. Both courts reviewing the "original" concluded that it resulted from an "exhaustive appraisal of Time's future as a corporation" and that the "Time board's decision" to enter into the original agreement (containing deal preservation provisions) with Warner "was entitled to the protection of the business judgment rule." 124 In my view, the strategic policy decision

protected in the original Time-Warner agreement cannot, like the NCS-Genesis merger of necessity here, be considered a responsive "defensive measure" compelling a *Unocal* analysis. By contrast, both courts concluded that the "revised" agreement was "defense-motivated" and as a result "Unocal alone applies to determine whether the business judgment rule attaches." [125]

124 *Id. at 1152.*
125 *Id. at 1151.*

Lockup provisions attempt to assure parties that have lost business opportunities and incurred substantial costs that their deal will close. [**107] I am concerned that the majority decision will remove the certainty that adds value to any rational business plan. Perhaps transactions that include "force-the-vote" and voting agreement provisions that make approval a foregone conclusion will be the only deals invalidated prospectively. Even so, therein lies the problem. Instead of thoughtful, retrospective, restrained flexibility focused on the circumstances existing at the time of the decision, have we now moved to a bright line regulatory alternative?

For the majority to articulate and adopt an inflexible rule where a board has discharged both its fiduciary duty of loyalty and care in good faith seems a most unfortunate turn. Does the majority mean to signal a mandatory, bright line, *per se* efficient breach analysis *ex post* to all challenged merger agreements? Knowing the majority's general, genuine concern to do equity, I trust not. If so, our courts and the structure of our law that we have strived so hard to develop and perfect will prevent a board, responsible under Delaware law to make precisely the kind of decision made here, in good faith, free of self interest, after exercising scrupulous due care from honoring [**108] its contract obligations.

Therefore, I respectfully dissent.

TAB "13"

LEXSEE 637 A2D 34

PARAMOUNT COMMUNICATIONS INC., VIACOM INC., MARTIN S. DAVIS, GRACE J. FIPPINGER, IRVING R. FISCHER, BENJAMIN L. HOOKS, FRANZ J. LUTOLF, JAMES A. PATTISON, IRWIN SCHLOSS, SAMUEL J. SILBERMAN, LAWRENCE M. SMALL, and GEORGE WEISSMAN, Defendants Below, Appellants, v. QVC NETWORK INC., Plaintiff Below, Appellee. IN RE PARAMOUNT COMMUNICATIONS INC. SHAREHOLDERS' LITIGATION

Nos. 427, 1993 and 428, 1993 (Consolidated) C.A. No. 13117 (Consolidated)

SUPREME COURT OF DELAWARE

637 A.2d 34; *1994 Del. LEXIS 57*; *Fed. Sec. L. Rep. (CCH) P98,063*

December 9, 1993, Submitted
February 4, 1994, Decided

SUBSEQUENT HISTORY: [**1] Released for Publication March 11, 1994. Mandate December 9, 1993.

PRIOR HISTORY: Court Below: Court of Chancery of the State of Delaware in and for New Castle County. C.A. No. 13208. Decided by Order: December 9, 1993.

Original Opinion of December 9, 1993, Reported at: *1993 Del. LEXIS 440*.

DISPOSITION: AFFIRMED.

COUNSEL: Charles F. Richards, Jr., Thomas A. Beck, and Anne C. Foster, Esquires, of RICHARDS, LAYTON & FINGER, Wilmington, Delaware; Barry R. Ostrager (Argued), Michael J. Chepiga, Robert F. Cusumano, Mary Kay Vyskocil, and Peter C. Thomas, Esquires, of SIMPSON THACHER & BARTLETT, New York, New York; Attorneys for Appellants Paramount Communications Inc., and the Individual Defendants.

A. Gilchrist Sparks, III, and William M. Lafferty, Esquires of MORRIS, NICHOLS, ARSHT & TUNNELL, Wilmington, Delaware; Stuart J. Baskin (Argued), Jeremy G. Epstein, Alan S. Goudiss, and Seth J. Lapidow, Esquires, of SHEARMAN & STERLING, New York, New York; Attorneys for Appellant Viacom Inc.

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GROSS & GODDESS, P.A., Wilmington, Delaware; Daniel W. Krasner and Jeffrey G. Smith, Esquires, of WOLF, HALDENSTEIN, ADLER, FREEMAN & HERZ, New York, New York; Arthur N. Abbey (Argued) and Mark C. Gardy, Esquires, of ABBEY & ELLIS, New York, New York; Attorneys for the Shareholder Appellees.

JUDGES: Before VEASEY, Chief Justice, MOORE and HOLLAND, Justices.

OPINION BY: VEASEY

OPINION

[*36] VEASEY, Chief Justice

In this appeal we review an order of the Court of Chancery dated November 24, 1993 (the "November 24 Order"), preliminarily enjoining certain defensive measures designed to facilitate a so-called strategic alliance between Viacom Inc. ("Viacom") and Paramount Communications [**3] Inc. ("Paramount") approved by the board of directors of Paramount (the "Paramount Board" or the "Paramount directors") and to thwart an unsolicited, more valuable, tender offer by QVC Network Inc. ("QVC"). In affirming, we hold that the sale of control in this case, which is at the heart of the proposed strategic alliance, implicates enhanced judicial scrutiny of the conduct of the Paramount Board under *Unocal Corp. v. Mesa Petroleum Co., Del. Supr. 493 A.2d 946 (1985)*, and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., Del. Supr., 506 A.2d 173 (1986)*. We further hold that the conduct of the Paramount Board was not reasonable as to process or result.

QVC and certain stockholders of Paramount commenced separate actions (later consolidated) in the Court of Chancery seeking preliminary and permanent injunctive relief against Paramount, certain members of the Paramount Board, and Viacom. This action arises out of a proposed acquisition of Paramount by Viacom through a tender offer followed by a second-step merger (the "Paramount-Viacom transaction"), and a competing unsolicited tender offer by QVC. The Court of Chancery granted a preliminary injunction. *QVC Network, Inc.* [**4] *v. Paramount Communications Inc., Del. Ch., 635 A.2d 1245*, Jacobs, V.C. (1993) (the "Court of Chancery Opinion"). We affirmed by order dated December 9, 1993. *Paramount Communications Inc. v. QVC Network Inc., 1993 Del. LEXIS 440*, Del. Supr., Nos. 427 and 428, 1993, Veasey, C.J. (Dec. 9, 1993) (the "December 9 Order"). [1]

1 We accepted this expedited interlocutory appeal on November 29, 1993. After briefing and oral argument in this Court held on December 9, 1993, we issued our December 9 Order affirming the November 24 Order of the Court of Chancery. In our December 9 Order, we stated, "It is not feasible, because of the exigencies of time, for this Court to complete an opinion setting forth more comprehensively the rationale of the Court's decision. Unless otherwise ordered by the Court such an opinion will follow in due course." December 9 Order 1993 Del. LEXIS 440, *2. This is the opinion referred to therein.

The Court of Chancery found that the Paramount directors violated their fiduciary duties [**5] by favoring the Paramount-Viacom transaction over the more valuable unsolicited offer of QVC. The Court of Chancery preliminarily enjoined Paramount and the individual defendants (the "Paramount defendants") from amending or modifying Paramount's stockholder rights agreement (the "Rights Agreement"), including the redemption of the Rights, or taking other action to facilitate the consummation of the pending tender offer by Viacom or any proposed second-step merger, including the Merger Agreement between Paramount and Viacom dated September 12, 1993 (the "Original Merger Agreement"), as amended on October 24, 1993 (the "Amended Merger Agreement"). Viacom and the Paramount defendants were enjoined from taking any action [*37] to exercise any provision of the Stock Option Agreement between Paramount and Viacom dated September 12, 1993 (the "Stock Option Agreement"), as amended on October 24, 1993. The Court of Chancery did not grant preliminary injunctive relief as to the termination fee provided for the benefit of Viacom in Section 8.05 of the Original Merger Agreement and the Amended Merger Agreement (the "Termination Fee").

Under the circumstances of this case, the pending sale [**6] of control implicated in the Paramount-Viacom transaction required the Paramount Board to act on an informed basis to secure the best value reasonably available to the stockholders. Since we agree with the Court of Chancery that the Paramount directors violated their fiduciary duties, we have AFFIRMED the entry of the order of the Vice Chancellor granting the preliminary injunction and have REMANDED these proceedings to the Court of Chancery for proceedings consistent herewith.

We also have attached an Addendum to this opinion addressing serious deposition misconduct by counsel who appeared on behalf of a Paramount director at the time that director's deposition was taken by a lawyer representing QVC. [2]

2 It is important to put the Addendum in perspective. This Court notes and has noted its appreciation of the outstanding judicial workmanship of the Vice Chancellor and the professionalism of counsel in this matter in handling this expedited litigation with the expertise and skill which characterize Delaware proceedings of this nature. The misconduct noted in the Addendum is an aberration which is not to be tolerated in any Delaware proceeding.

[**7] **I. FACTS**

The Court of Chancery Opinion contains a detailed recitation of its factual findings in this matter. Court of Chancery Opinion, 635 A.2d at 1246-1258. Only a brief summary of the facts is necessary for purposes of this opinion. The following summary is drawn from the findings of fact set forth in the Court of Chancery Opinion and our independent review of the record. [3]

3 This Court's standard and scope of review as to facts on appeal from a preliminary injunction is whether, after independently reviewing the entire record, we can conclude that the findings of the Court of Chancery are sufficiently supported by the record and are the product of an orderly and logical deductive process. *Ivanhoe Partners v. Newmont Mining Corp., Del. Supr., 535 A.2d 1334, 1342-41 (1987).*

Paramount is a Delaware corporation with its principal offices in New York City. Approximately 118 million shares of Paramount's common stock are outstanding and traded on the New York Stock Exchange. [**8] The majority of Paramount's stock is publicly held by numerous unaffiliated investors. Paramount owns and operates a diverse group of entertainment businesses, including motion picture and television studios, book publishers, professional sports teams and amusement parks.

There are 15 persons serving on the Paramount Board. Four directors are officer-employees of Paramount: Martin S. Davis ("Davis"), Paramount's Chairman and Chief Executive Officer since 1983; Donald Oresman ("Oresman"), Executive Vice-President, Chief Administrative Officer, and General Counsel; Stanley R. Jaffe, President and Chief Operating Officer; and Ronald L. Nelson, Executive Vice President and Chief Financial Officer. Paramount's 11 outside directors are distinguished and experienced business persons who are present or former senior executives of public corporations or financial institutions. [4]

4 Grace J. Fippinger, a former Vice President, Secretary and Treasurer of NYNEX Corporation, and director of Pfizer, Inc., Connecticut Mutual Life Insurance Company, and The Bear Stearns Companies, Inc.

Irving R. Fischer, Chairman and Chief Executive Officer of HRH Construction Corporation, Vice Chairman of the New York City Chapter of the National Multiple Sclerosis Society, a member of the New York City Holocaust Memorial Commission, and an Adjunct Professor of Urban Planning at Columbia University

Benjamin L. Hooks, Senior Vice President of the Chapman Company and director of Maxima Corporation

J. Hugh Liedtke, Chairman of Pennzoil Company

Franz J. Lutolf, former General Manager and a member of the Executive Board of Swiss Bank Corporation, and director of Grapha Holding AG, Hergiswil (Switzerland), Banco Santander (Suisse) S.A., Geneva, Diawa Securities Bank (Switzerland), Zurich, Cheak Coast Helarb European Acquisitions S.A., Luxembourg Internationale Nederlanden Bank (Switzerland), Zurich

James A. Pattison, Chairman and Chief Executive Officer of the Jim Pattison Group, and director of the Toronto-Dominion Bank, Canadian Pacific Ltd., and Toyota's Canadian subsidiary

Lester Pollack, General Partner of Lazard Freres & Co., Chief Executive Officer of Center Partners, and Senior Managing Director of Corporate Partners, investment affiliates of Lazard Freres, director of Loews Corp., CNA Financial Corp., Sunamerica Corp., Kaufman & Broad Home Corp., Parlex Corp., Transco Energy Company, Polaroid Corp., Continental Cablevision, Inc., and Tidewater Inc., and Trustee of New York University

Irwin Schloss, Senior Advisor, Marcus Schloss & Company, Inc.

Samuel J. Silberman, Retired Chairman of Consolidated Cigar Corporation

Lawrence M. Small, President and Chief Operating Officer of the Federal National Mortgage Association, director of Fannie Mae and the Chubb Corporation, and trustee of Morehouse College and New York University Medical Center

George Weissman, retired Chairman and Consultant of Philip Morris Companies, Inc., director of Avnet, Incorporated, and Chairman of Lincoln Center for the Performing Arts, Inc.

[**9] [*38] Viacom is a Delaware corporation with its headquarters in Massachusetts. Viacom is controlled by Sumner M. Redstone ("Redstone"), its Chairman and Chief Executive Officer, who owns indirectly approximately 85.2 percent of Viacom's voting Class A stock and approximately 69.2 percent of Viacom's nonvoting Class B stock through National Amusements, Inc. ("NAI"), an entity 91.7 percent owned by Redstone. Viacom has a wide range of entertainment operations, including a number of well-known cable television channels such as MTV, Nickelodeon, Showtime, and The Movie Channel. Viacom's equity co-investors in the Paramount-Viacom transaction include NYNEX Corporation and Blockbuster Entertainment Corporation.

QVC is a Delaware corporation with its headquarters in West Chester, Pennsylvania. QVC has several large stockholders, including Liberty Media Corporation, Comcast Corporation, Advance Publications, Inc., and Cox Enterprises Inc. Barry Diller ("Diller"), the Chairman and Chief Executive Officer of QVC, is also a substantial stockholder. QVC sells a variety of merchandise through a televised shopping channel. QVC has several equity co-investors in its proposed combination with [**10] Paramount including BellSouth Corporation and Comcast Corporation.

Beginning in the late 1980s, Paramount investigated the possibility of acquiring or merging with other companies in the entertainment, media, or communications industry. Paramount considered such transactions to be desirable, and perhaps necessary, in order to keep pace with competitors in the rapidly evolving field of entertainment and communications. Consistent with its goal of strategic expansion, Paramount made a tender offer for Time Inc. in 1989, but was ultimately unsuccessful. *See Paramount Communications, Inc. v. Time Inc., Del. Supr., 571 A.2d 1140 (1990) ("Time-Warner").*

Although Paramount had considered a possible combination of Paramount and Viacom as early as 1990, recent efforts to explore such a transaction began at a dinner meeting between Redstone and Davis on April 20, 1993. Robert Greenhill ("Greenhill"), Chairman of Smith Barney Shearson Inc. ("Smith Barney"), attended and helped facilitate this meeting. After several more meetings between Redstone and Davis, serious negotiations began taking place in early July.

It was tentatively agreed that Davis would be the chief executive officer [**11] and Redstone would be the controlling stockholder of the combined company, but the parties could not reach agreement on the merger price and the terms of a stock option to be granted to Viacom. With respect to price, Viacom offered a package of cash and stock (primarily Viacom Class B nonvoting stock) with a market value of approximately $ 61 per share, but Paramount wanted at least $ 70 per share.

Shortly after negotiations broke down in July 1993, two notable events occurred. First, Davis apparently learned of QVC's potential interest in Paramount, and told Diller over lunch on July 21, 1993, that Paramount was not for sale. Second, the market value of Viacom's Class B nonvoting stock increased from $ 46.875 on July 6 to $ 57.25 on August 20. QVC claims (and Viacom disputes) that this price increase was caused by open market purchases of such stock by Redstone or entities controlled by him.

[*39] On August 20, 1993, discussions between Paramount and Viacom resumed when Greenhill arranged another meeting between Davis and Redstone. After a short hiatus, the parties negotiated in earnest in early September, and performed due diligence with the assistance of their financial advisors, [**12] Lazard Freres & Co. ("Lazard") for Paramount and Smith Barney for Viacom. On September 9, 1993, the Paramount Board was informed about the status of the negotiations and was provided information by Lazard, including an analysis of the proposed transaction.

On September 12, 1993, the Paramount Board met again and unanimously approved the Original Merger Agreement whereby Paramount would merge with and into Viacom. The terms of the merger provided that each share of Paramount common stock would be converted into 0.10 shares of Viacom Class A voting stock, 0.90 shares of Viacom Class B nonvoting stock, and $ 9.10 in cash. In addition, the Paramount Board agreed to amend its "poison pill" Rights Agreement to exempt the proposed merger with Viacom. The Original Merger Agreement also contained several provisions designed to make it more difficult for a potential competing bid to succeed. We focus, as did the Court of Chancery, on three of these defensive provisions: a "no-shop" provision (the "No-Shop Provision"), the Termination Fee, and the Stock Option Agreement.

First, under the No-Shop Provision, the Paramount Board agreed that Paramount would not solicit, encourage, discuss, negotiate, [**13] or endorse any competing transaction unless: (a) a third party "makes an unsolicited written, bona fide proposal, which is not subject to any material contingencies relating to financing"; and (b) the Paramount Board determines that discussions or negotiations with the third party are necessary for the Paramount Board to comply with its fiduciary duties.

Second, under the Termination Fee provision, Viacom would receive a $ 100 million termination fee if: (a) Paramount terminated the Original Merger Agreement because of a competing transaction; (b) Paramount's stockholders did not approve the merger; or (c) the Paramount Board recommended a competing transaction.

The third and most significant deterrent device was the Stock Option Agreement, which granted to Viacom an option to purchase approximately 19.9 percent (23,699,000 shares) of Paramount's outstanding common stock at $ 69.14 per share if any of the triggering events for the Termination Fee occurred. In addition to the customary terms that are normally associated with a stock option, the Stock Option Agreement contained two provisions that were both unusual and highly beneficial to Viacom: (a) Viacom was permitted to pay for [**14] the shares with a senior subordinated note of questionable marketability instead of cash, thereby avoiding the need to raise the $ 1.6 billion purchase price (the "Note Feature"); and (b) Viacom could elect to require Paramount to pay Viacom in cash a sum equal to the difference between the purchase price and the market price of Paramount's stock (the "Put Feature"). Because the Stock Option Agreement was not "capped" to limit its maximum dollar value, it had the potential to reach (and in this case did reach) unreasonable levels.

After the execution of the Original Merger Agreement and the Stock Option Agreement on September 12, 1993, Paramount and Viacom announced their proposed merger. In a number of public statements, the parties indicated that the pending transaction was a virtual certainty. Redstone described it as a "marriage" that would "never be torn asunder"

and stated that only a "nuclear attack" could break the deal. Redstone also called Diller and John Malone of Tele-Communications Inc., a major stockholder of QVC, to dissuade them from making a competing bid.

Despite these attempts to discourage a competing bid, Diller sent a letter to Davis on September 20, 1993, proposing [**15] a merger in which QVC would acquire Paramount for approximately $ 80 per share, consisting of 0.893 shares of QVC common stock and $ 30 in cash. QVC also expressed its eagerness to meet with Paramount to negotiate the details of a transaction. When the Paramount Board met on September 27, it was advised by Davis that the Original Merger [*40] Agreement prohibited Paramount from having discussions with QVC (or anyone else) unless certain conditions were satisfied. In particular, QVC had to supply evidence that its proposal was not subject to financing contingencies. The Paramount Board was also provided information from Lazard describing QVC and its proposal.

On October 5, 1993, QVC provided Paramount with evidence of QVC's financing. The Paramount Board then held another meeting on October 11, and decided to authorize management to meet with QVC. Davis also informed the Paramount Board that Booz-Allen & Hamilton ("Booz-Allen"), a management consulting firm, had been retained to assess, *inter alia,* the incremental earnings potential from a Paramount-Viacom merger and a Paramount-QVC merger. Discussions proceeded slowly, however, due to a delay in Paramount signing a confidentiality [**16] agreement. In response to Paramount's request for information, QVC provided two binders of documents to Paramount on October 20.

On October 21, 1993, QVC filed this action and publicly announced an $ 80 cash tender offer for 51 percent of Paramount's outstanding shares (the "QVC tender offer"). Each remaining share of Paramount common stock would be converted into 1.42857 shares of QVC common stock in a second-step merger. The tender offer was conditioned on, among other things, the invalidation of the Stock Option Agreement, which was worth over $ 200 million by that point. 5 QVC contends that it had to commence a tender offer because of the slow pace of the merger discussions and the need to begin seeking clearance under federal antitrust laws.

5 By November 15, 1993, the value of the Stock Option Agreement had increased to nearly $ 500 million based on the $ 90 QVC bid. *See* Court of Chancery Opinion, 635 A.2d at 1271.

Confronted by QVC's hostile bid, which on its face offered [**17] over $ 10 per share more than the consideration provided by the Original Merger Agreement, Viacom realized that it would need to raise its bid in order to remain competitive. Within hours after QVC's tender offer was announced, Viacom entered into discussions with Paramount concerning a revised transaction. These discussions led to serious negotiations concerning a comprehensive amendment to the original Paramount-Viacom transaction. In effect, the opportunity for a "new deal" with Viacom was at hand for the Paramount Board. With the QVC hostile bid offering greater value to the Paramount stockholders, the Paramount Board had considerable leverage with Viacom.

At a special meeting on October 24, 1993, the Paramount Board approved the Amended Merger Agreement and an amendment to the Stock Option Agreement. The Amended Merger Agreement was, however, essentially the same as the Original Merger Agreement, except that it included a few new provisions. One provision related to an $ 80 per share cash tender offer by Viacom for 51 percent of Paramount's stock, and another changed the merger consideration so that each share of Paramount would be converted into 0.20408 shares of Viacom Class [**18] A voting stock, 1.08317 shares of Viacom Class B nonvoting stock, and 0.20408 shares of a new series of Viacom convertible preferred stock. The Amended Merger Agreement also added a provision giving Paramount the right not to amend its Rights Agreement to exempt Viacom if the Paramount Board determined that such an amendment would be inconsistent with its fiduciary duties because another offer constituted a "better alternative." 6 Finally, the Paramount Board was given the power to terminate the Amended Merger Agreement if it withdrew its recommendation of the Viacom transaction or recommended a competing transaction.

6 Under the Amended Merger Agreement and the Paramount Board's resolutions approving it, no further action of the Paramount Board would be required in order for Paramount's Rights Agreement to be amended. As

a result, the proper officers of the company were authorized to implement the amendment unless they were instructed otherwise by the Paramount Board.

Although the Amended Merger Agreement [**19] offered more consideration to the Paramount stockholders and somewhat more flexibility to the Paramount Board than did the Original Merger Agreement, the defensive measures designed to make a competing bid more difficult were not removed or modified. [*41] In particular, there is no evidence in the record that Paramount sought to use its newly-acquired leverage to eliminate or modify the No-Shop Provision, the Termination Fee, or the Stock Option Agreement when the subject of amending the Original Merger Agreement was on the table.

Viacom's tender offer commenced on October 25, 1993, and QVC's tender offer was formally launched on October 27, 1993. Diller sent a letter to the Paramount Board on October 28 requesting an opportunity to negotiate with Paramount, and Oresman responded the following day by agreeing to meet. The meeting, held on November 1, was not very fruitful, however, after QVC's proposed guidelines for a "fair bidding process" were rejected by Paramount on the ground that "auction procedures" were inappropriate and contrary to Paramount's contractual obligations to Viacom.

On November 6, 1993, Viacom unilaterally raised its tender offer price to $ 85 per share [**20] in cash and offered a comparable increase in the value of the securities being proposed in the second-step merger. At a telephonic meeting held later that day, the Paramount Board agreed to recommend Viacom's higher bid to Paramount's stockholders.

QVC responded to Viacom's higher bid on November 12 by increasing its tender offer to $ 90 per share and by increasing the securities for its second-step merger by a similar amount. In response to QVC's latest offer, the Paramount Board scheduled a meeting for November 15, 1993. Prior to the meeting, Oresman sent the members of the Paramount Board a document summarizing the "conditions and uncertainties" of QVC's offer. One director testified that this document gave him a very negative impression of the QVC bid.

At its meeting on November 15, 1993, the Paramount Board determined that the new QVC offer was not in the best interests of the stockholders. The purported basis for this conclusion was that QVC's bid was excessively conditional. The Paramount Board did not communicate with QVC regarding the status of the conditions because it believed that the No-Shop Provision prevented such communication in the absence of firm financing. Several [**21] Paramount directors also testified that they believed the Viacom transaction would be more advantageous to Paramount's future business prospects than a QVC transaction. [7] Although a number of materials were distributed to the Paramount Board describing the Viacom and QVC transactions, the only quantitative analysis of the consideration to be received by the stockholders under each proposal was based on then-current market prices of the securities involved, not on the anticipated value of such securities at the time when the stockholders would receive them. [8]

7 This belief may have been based on a report prepared by Booz-Allen and distributed to the Paramount Board at its October 24 meeting. The report, which relied on public information regarding QVC, concluded that the synergies of a Paramount-Viacom merger were significantly superior to those of a Paramount-QVC merger. QVC has labelled the Booz-Allen report as a "joke."

8 The market prices of Viacom's and QVC's stock were poor measures of their actual values because such prices constantly fluctuated depending upon which company was perceived to be the more likely to acquire Paramount.

[**22] The preliminary injunction hearing in this case took place on November 16, 1993. On November 19, Diller wrote to the Paramount Board to inform it that QVC had obtained financing commitments for its tender offer and that there was no antitrust obstacle to the offer. On November 24, 1993, the Court of Chancery issued its decision granting a preliminary injunction in favor of QVC and the plaintiff stockholders. This appeal followed.

II. APPLICABLE PRINCIPLES OF ESTABLISHED DELAWARE LAW

The General Corporation Law of the State of Delaware (the "General Corporation Law") and the decisions of this

Court have repeatedly recognized the fundamental principle that the management of the business and affairs of a Delaware corporation is entrusted to its directors, who are the duly elected and authorized representatives of the [*42] stockholders. *8 Del. C. § 141(a)*; *Aronson v. Lewis, Del. Supr., 473 A.2d 805, 811-12 (1984)*; *Pogostin v. Rice, Del. Supr., 480 A.2d 619, 624 (1984)*. Under normal circumstances, neither the courts nor the stockholders should interfere with the managerial decisions of the directors. The business judgment rule embodies the deference to which [**23] such decisions are entitled. *Aronson, 473 A.2d at 812.*

Nevertheless, there are rare situations which mandate that a court take a more direct and active role in overseeing the decisions made and actions taken by directors. In these situations, a court subjects the directors' conduct to enhanced scrutiny to ensure that it is reasonable. [9] The decisions of this Court have clearly established the circumstances where such enhanced scrutiny will be applied. *E.g., Unocal, 493 A.2d 946*; *Moran v. Household Int'l, Inc., Del. Supr., 500 A.2d 1346 (1985)*; *Revlon, 506 A.2d 173*; *Mills Acquisition Co. v. Macmillan, Inc., Del. Supr., 559 A.2d 1261 (1989)*; *Gilbert v. El Paso Co., Del. Supr., 575 A.2d 1131 (1990)*. The case at bar implicates two such circumstances: (1) the approval of a transaction resulting in a sale of control, and (2) the adoption of defensive measures in response to a threat to corporate control.

9 Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply even more exacting scrutiny to determine whether the transaction is entirely fair to the stockholders. *E.g., Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701, 710-11 (1983)*; *Nixon v. Blackwell, Del. Supr., 626 A.2d 1366, 1376 (1993).*

[**24]

A. The Significance of a Sale or Change [10] of Control

10 For purposes of our December 9 Order and this Opinion, we have used the terms "sale of control" and "change of control" interchangeably without intending any doctrinal distinction.

When a majority of a corporation's voting shares are acquired by a single person or entity, or by a cohesive group acting together, there is a significant diminution in the voting power of those who thereby become minority stockholders. Under the statutory framework of the General Corporation Law, many of the most fundamental corporate changes can be implemented only if they are approved by a majority vote of the stockholders. Such actions include elections of directors, amendments to the certificate of incorporation, mergers, consolidations, sales of all or substantially all of the assets of the corporation, and dissolution. *8 Del. C. §§ 211, 242, 251-258, 263, 271, 275.* Because of the overriding importance of voting rights, this Court and the Court [**25] of Chancery have consistently acted to protect stockholders from unwarranted interference with such rights. [11]

11 *See Schnell v. Chris-Craft Indus., Inc., Del. Supr., 285 A.2d 437, 439 (1971)* (holding that actions taken by management to manipulate corporate machinery "for the purpose of obstructing the legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management" were "contrary to established principles of corporate democracy" and therefore invalid); *Giuricich v. Emtrol Corp., Del. Supr., 449 A.2d 232, 239 (1982)* (holding that "careful judicial scrutiny will be given a situation in which the right to vote for the election of successor directors has been effectively frustrated"); *Centaur Partners, IV v. Nat'l Intergroup, Del. Supr., 582 A.2d 923 (1990)* (holding that supermajority voting provisions must be clear and unambiguous because they have the effect of disenfranchising the majority); *Stroud v. Grace, Del. Supr., 606 A.2d 75, 84 (1992)* (directors' duty of disclosure is premised on the importance of stockholders being fully informed when voting on a specific matter); *Blasius Indus., Inc. v. Atlas Corp., Del. Ch., 564 A.2d 651, 659 n. 2 (1988)* ("Delaware courts have long exercised a most sensitive and protective regard for the free and effective exercise of voting rights.").

[**26] In the absence of devices protecting the minority stockholders, [12] stockholder votes are likely to become mere formalities where there is a majority stockholder. For example, minority stockholders can be deprived of a continuing equity interest in their corporation by means of a cash-out merger. *Weinberger,* [*43] *457 A.2d at 703.* Absent effective protective provisions, minority stockholders must rely for protection solely on the fiduciary duties owed to them by the directors and the majority stockholder, since the minority stockholders have lost the power to influence corporate direction through the ballot. The acquisition of majority status and the consequent privilege of exerting the powers of majority ownership come at a price. That price is usually a control premium which recognizes not only the value of a control block of shares, but also compensates the minority stockholders for their resulting loss of voting power.

12 Examples of such protective provisions are supermajority voting provisions, majority of the minority requirements, etc. Although we express no opinion on what effect the inclusion of any such stockholder protective devices would have had in this case, we note that this Court has upheld, under different circumstances, the reasonableness of a standstill agreement which limited a 49.9 percent stockholder to 40 percent board representation. *Ivanhoe, 535 A.2d at 1343.*

[**27] In the case before us, the public stockholders (in the aggregate) currently own a majority of Paramount's voting stock. Control of the corporation is not vested in a single person, entity, or group, but vested in the fluid aggregation of unaffiliated stockholders. In the event the Paramount-Viacom transaction is consummated, the public stockholders will receive cash and a minority equity voting position in the surviving corporation. Following such consummation, there will be a controlling stockholder who will have the voting power to: (a) elect directors; (b) cause a break-up of the corporation: (c) merge it with another company; (d) cash-out the public stockholders: (e) amend the certificate of incorporation; (f) sell all or substantially all of the corporate assets; or (g) otherwise alter materially the nature of the corporation and the public stockholders' interests. Irrespective of the present Paramount Board's vision of a long-term strategic alliance with Viacom, the proposed sale of control would provide the new controlling stockholder with the power to alter that vision.

Because of the intended sale of control, the Paramount-Viacom transaction has economic consequences of [**28] considerable significance to the Paramount stockholders. Once control has shifted, the current Paramount stockholders will have no leverage in the future to demand another control premium. As a result, the Paramount stockholders are entitled to receive, and should receive, a control premium and/or protective devices of significant value. There being no such protective provisions in the Viacom-Paramount transaction, the Paramount directors had an obligation to take the maximum advantage of the current opportunity to realize for the stockholders the best value reasonably available.

B. The Obligations of Directors in a Sale or Change of Control Transaction

The consequences of a sale of control impose special obligations on the directors of a corporation. [13] In particular, they have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders. The courts will apply enhanced scrutiny to ensure that the directors have acted reasonably. The obligations of the directors and the enhanced scrutiny of the courts are well-established by the decisions of this Court. The directors' fiduciary duties in a sale of control [**29] context are those which generally attach. In short, "the directors must act in accordance with their fundamental duties of care and loyalty." *Barkan v. Amsted Indus., Inc., Del. Supr., 567 A.2d 1279, 1286 (1989).* As we held in *Macmillan:*

> It is basic to our law that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation. In discharging this function, the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders. **This unremitting obligation extends equally to board conduct in a sale of corporate control.**

[*44] *559 A.2d at 1280* (emphasis supplied) (citations omitted).

13 We express no opinion on any scenario except the actual facts before the Court, and our precise holding herein. Unsolicited tender offers in other contexts may be governed by different precedent. For example, where a potential sale of control by a corporation is not the consequence of a board's action, this Court has recognized the prerogative of a board of directors to resist a third party's unsolicited acquisition proposal or offer. *See Pogostin, 480 A.2d at 627*; *Time-Warner, 571 A.2d at 1152*; *Bershad v. Curtiss-Wright Corp., Del. Supr., 535 A.2d 840, 845 (1987)*; *Macmillan, 559 A.2d at 1285 n. 35*. The decision of a board to resist such an acquisition, like all decisions of a properly-functioning board, must be informed, *Unocal, 493 A.2d at 954-55*, and the circumstances of each particular case will determine the steps that a board must take to inform itself, and what other action, if any, is required as a matter of fiduciary duty.

[**30] In the sale of control context, the directors must focus on one primary objective--to secure the transaction offering the best value reasonably available for the stockholders--and they must exercise their fiduciary duties to further that end. The decisions of this Court have consistently emphasized this goal. *Revlon, 506 A.2d at 182* ("The duty of the board . . . [is] the maximization of the company's value at a sale for the stockholders' benefit."); *Macmillan, 559 A.2d at 1288* ("In a sale of corporate control the responsibility of the directors is to get the highest value reasonably attainable for the shareholders."); *Barkan, 567 A.2d at 1286* ("The board must act in a neutral manner to encourage the highest possible price for shareholders."). *See also Wilmington Trust Co. v. Coulter, Del. Supr., 41 Del. Ch. 548, 200 A.2d 441, 448 (1964)* (in the context of the duty of a trustee, "when all is equal . . . it is plain that the Trustee is bound to obtain the best price obtainable").

In pursuing this objective, the directors must be especially diligent. *See Citron v. Fairchild Camera and Instrument Corp., Del. Supr., 569 A.2d 53, 66 (1989)* (discussing "a board's [**31] active and direct role in the sale process"). In particular, this Court has stressed the importance of the board being adequately informed in negotiating a sale of control: "The need for adequate information is central to the enlightened evaluation of a transaction that a board must make." *Barkan, 567 A.2d at 1287*. This requirement is consistent with the general principle that "directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them." *Aronson, 473 A.2d at 812*. *See also Cede & Co. v. Technicolor, Inc., Del. Supr., 634 A.2d 345, 367 (1993)*; *Smith v. Van Gorkom, Del. Supr., 488 A.2d 858, 872 (1985)*. Moreover, the role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management may not necessarily be impartial. *See Macmillan, 559 A.2d at 1285* (requiring "the intense scrutiny and participation of the independent directors").

Barkan teaches some of the methods by which a board can fulfill its obligation to seek the best value reasonably available to the stockholders. [**32] *567 A.2d at 1286-87*. These methods are designed to determine the existence and viability of possible alternatives. They include conducting an auction, canvassing the market, etc. Delaware law recognizes that there is "no single blueprint" that directors must follow. *567 A.2d at 1286-1287*; *Citron 569 A.2d at 68*; *Macmillan, 559 A.2d at 1287*.

In determining which alternative provides the best value for the stockholders, a board of directors is not limited to considering only the amount of cash involved, and is not required to ignore totally its view of the future value of a strategic alliance. *See Macmillan, 559 A.2d at 1282 n. 29*. Instead, the directors should analyze the entire situation and evaluate in a disciplined manner the consideration being offered. Where stock or other non-cash consideration is involved, the board should try to quantify its value, if feasible, to achieve an objective comparison of the alternatives. 14 In addition, the board may assess a variety of practical considerations relating to each alternative including:

> [an offer's] fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; [**33] questions of illegality; . . . the risk of non-consummation; . . . the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on stockholder interests.

Macmillan, 559 A.2d at 1282 n. 29. These considerations are important because the selection of one alternative may

permanently foreclose other opportunities. While the assessment of these factors may be complex, [*45] the board's goal is straightforward: Having informed themselves of all material information reasonably available, the directors must decide which alternative is most likely to offer the best value reasonably available to the stockholders.

14 When assessing the value of non-cash consideration, a board should focus on its value as of the date it will be received by the stockholders. Normally, such value will be determined with the assistance of experts using generally accepted methods of valuation. *See In re RJR Nabisco, Inc. Shareholders Litig., 1989 Del. Ch. LEXIS 9*, Del. Ch., C.A. No. 10389, Allen, C. (Jan. 31, 1989), reprinted at *14 Del. J. Corp. L. 1132, 1161.*

[**34]

C. Enhanced Judicial Scrutiny of a Sale or Change of Control Transaction

Board action in the circumstances presented here is subject to enhanced scrutiny. Such scrutiny is mandated by: (a) the threatened diminution of the current stockholders' voting power; (b) the fact that an asset belonging to public stockholders (a control premium) is being sold and may never be available again: and (c) the traditional concern of Delaware courts for actions which impair or impede stockholder voting rights (see *supra* note 11). In *Macmillan*, this Court held:

> When *Revlon* duties devolve upon directors, this Court will continue to exact an enhanced judicial scrutiny at the threshold, as in *Unocal*, before the normal presumptions of the business judgment rule will apply. [15]

559 A.2d at 1288. The *Macmillan* decision articulates a specific two-part test for analyzing board action where competing bidders are not treated equally: [16]

> In the face of disparate treatment, the trial court must first examine whether the directors properly perceived that shareholder interests were enhanced. In any event the board's action must be reasonable in relation to the [**35] advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests.

Id. See also Roberts v. General Instrument Corp., 1990 Del. Ch. LEXIS 138, Del. Ch., C.A. No. 11639, Allen, C. (Aug. 13, 1990), reprinted at *16 Del. J. Corp. L. 1540, 1554* ("This enhanced test requires a judicial judgment of reasonableness in the circumstances.").

15 Because the Paramount Board acted unreasonably as to process and result in this sale of control situation, the business judgment rule did not become operative.

16 Before this test is invoked, "the plaintiff must show, and the trial court must find, that the directors of the target company treated one or more of the respective bidders on unequal terms." *Macmillan, 559 A.2d at 1288.*

The key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decisionmaking process employed by the directors, including the information on which the directors based their decision; and (b) a judicial [**36] examination of the reasonableness of the directors' action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.

Although an enhanced scrutiny test involves a review of the reasonableness of the substantive merits of a board's actions, [17] a court should not ignore the complexity of the directors' task in a sale of control. There are many business and financial considerations implicated in investigating and selecting the best value reasonably available. The board of directors is the corporate decisionmaking body best equipped to make these judgments. Accordingly, a court applying enhanced judicial scrutiny should be deciding whether the directors made **a reasonable** decision, not **a perfect** decision.

If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness. [**37] [*46] *See Unocal, 493 A.2d at 955-56*; *Macmillan, 559 A.2d at 1288*; *Nixon, 626 A.2d at 1378.*

17 It is to be remembered that, in cases where the traditional business judgment rule is applicable and the board acted with due care, in good faith, and in the honest belief that they are acting in the best interests of the stockholders (which is not this case), the Court gives great deference to the substance of the directors' decision and will not invalidate the decision, will not examine its reasonableness, and "will not substitute our views for those of the board if the latter's decision can be 'attributed to any rational business purpose.'" *Unocal, 493 A.2d at 949 (quoting Sinclair Oil Corp. v. Levien, Del. Supr., 280 A.2d 717, 720 (1971)). See Aronson, 473 A.2d at 812.*

D. Revlon and Time-Warner Distinguished

The Paramount defendants and Viacom assert that the fiduciary obligations and the enhanced judicial scrutiny discussed above are not implicated in this [**38] case in the absence of a "break-up" of the corporation, and that the order granting the preliminary injunction should be reversed. This argument is based on their erroneous interpretation of our decisions in *Revlon* and *Time-Warner.*

In *Revlon,* we reviewed the actions of the board of directors of Revlon, Inc. ("Revlon"), which had rebuffed the overtures of Pantry Pride, Inc. and had instead entered into an agreement with Forstmann Little & Co. ("Forstmann") providing for the acquisition of 100 percent of Revlon's outstanding stock by Forstmann and the subsequent break-up of Revlon. Based on the facts and circumstances present in *Revlon,* we held that "the directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *506 A.2d at 182.* We further held that "when a board ends an intense bidding contest on an insubstantial basis, . . . [that] action cannot withstand the enhanced scrutiny which *Unocal* requires of director conduct." *506 A.2d at 184.*

It is true that one of the circumstances bearing on these holdings was the fact that "the break-up of the company . . . had [**39] become a reality which even the directors embraced." *506 A.2d at 182.* It does not follow, however, that a "break-up" must be present and "inevitable" before directors are subject to enhanced judicial scrutiny and are required to pursue a transaction that is calculated to produce the best value reasonably available to the stockholders. In fact, we stated in *Revlon* that "when bidders make relatively similar offers, **or** dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions." *506 A.2d at 184* (emphasis added). *Revlon* thus does not hold that an inevitable dissolution or "break-up" is necessary.

The decisions of this Court following *Revlon* reinforced the applicability of enhanced scrutiny and the directors' obligation to seek the best value reasonably available for the stockholders where there is a pending sale of control, regardless of whether or not there is to be a break-up of the corporation. In *Macmillan,* this Court held:

> We stated in *Revlon,* and again here, that **in a sale of corporate control** the responsibility of the directors is to get the highest [**40] value reasonably attainable for the shareholders.

559 A.2d at 1288 (emphasis added). In *Barkan,* we observed further:

> We believe that the general principles announced in *Revlon,* in *Unocal Corp. v. Mesa Petroleum Co., Del. Supr., 493 A.2d 946 (1985)*, and in *Moran v. Household International, Inc., Del. Supr., 500 A.2d*

> *1346 (1985)* govern this case and every case in which a **fundamental change of corporate control** occurs or is contemplated.

567 A.2d at 1286 (emphasis added).

Although *Macmillan* and *Barkan* are clear in holding that a change of control imposes on directors the obligation to obtain the best value reasonably available to the stockholders, the Paramount defendants have interpreted our decision in *Time-Warner* as requiring a corporate break-up in order for that obligation to apply. The facts in *Time-Warner,* however, were quite different from the facts of this case, and refute Paramount's position here. In *Time-Warner,* the Chancellor held that there was no change of control in the original stock-for-stock merger between Time and Warner because Time would be owned by a fluid aggregation of unaffiliated stockholders [**41] both before and after the merger:

> If the appropriate inquiry is whether a change in control is contemplated, the answer must be sought in the specific circumstances surrounding the transaction. Surely under some circumstances a stock for stock merger could reflect a transfer of corporate control. That would, for example, plainly be the case here if Warner were a private company. But where, as [*47] here, the shares of both constituent corporations are widely held, corporate control can be expected to remain unaffected by a stock for stock merger. This in my judgment was the situation with respect to the original merger agreement. When the specifics of that situation are reviewed, it is seen that, aside from legal technicalities and aside from arrangements thought to enhance the prospect for the ultimate succession of [Nicholas J. Nicholas, Jr., president of Time], neither corporation could be said to be acquiring the other. **Control of both remained in a large, fluid, changeable and changing market.**
>
> The existence of a control block of stock in the hands of a single shareholder or a group with loyalty to each other does have real consequences to the financial value [**42] of "minority" stock. The law offers some protection to such shares through the imposition of a fiduciary duty upon controlling shareholders. **But here, effectuation of the merger would not have subjected Time shareholders to the risks and consequences of holders of minority shares. This is a reflection of the fact that no control passed to anyone in the transaction contemplated.** The shareholders of Time would have "suffered" dilution, of course, but they would suffer the same type of dilution upon the public distribution of new stock.

Paramount Communications Inc. v. Time Inc., Del. Ch., No. 10866, Allen, C. (July 17, 1989), reprinted at *15 Del. J. Corp. L. 700, 739* (emphasis added). Moreover, the transaction actually consummated in *Time-Warner* was not a merger, as originally planned, but a sale of Warner's stock to Time.

In our affirmance of the Court of Chancery's well-reasoned decision, this Court held that "The Chancellor's findings of fact are supported by the record and **his conclusion is correct as a matter of law."** *571 A.2d at 1150* (emphasis added). Nevertheless, the Paramount defendants here have argued that a break-up is a requirement and have focused [**43] on the following language in our *Time-Warner* decision:

> However, we premise our rejection of plaintiffs' *Revlon* claim on different grounds, namely, the absence of any substantial evidence to conclude that Time's board, in negotiating with Warner, made the dissolution or break-up of the corporate entity inevitable, as was the case in *Revlon.*
>
> Under Delaware law there are, generally speaking and **without excluding other possibilities,** two circumstances which may implicate *Revlon* duties. The first, and clearer one, is when a corporation **initiates an active bidding process seeking to sell itself** or to effect a business reorganization involving a clear breakup of the company. However, *Revlon* duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the

breakup of the company.

Id. at 1150 (emphasis added) (citation and footnote omitted).

The Paramount defendants have misread the holding of *Time-Warner.* Contrary to their argument, our decision in *Time-Warner* expressly states that the two general scenarios discussed in the above-quoted [**44] paragraph are not the **only** instances where *"Revlon* duties" may be implicated. The Paramount defendants' argument totally ignores the phrase "without excluding other possibilities." Moreover, the instant case is clearly within the first general scenario set forth in *Time-Warner.* The Paramount Board, albeit unintentionally, had "initiated an active bidding process seeking to sell itself" by agreeing to sell control of the corporation to Viacom in circumstances where another potential acquiror (QVC) was equally interested in being a bidder.

The Paramount defendants' position that **both** a change of control **and** a break-up are **required** must be rejected. Such a holding would unduly restrict the application of *Revlon,* is inconsistent with this Court's decisions in *Barkan* and *Macmillan,* and has no basis in policy. There are few events that have a more significant impact on the stockholders than a sale of control or a corporate break-up. Each event represents a fundamental [*48] (and perhaps irrevocable) change in the nature of the corporate enterprise from a practical standpoint. It is the significance of **each** of these events that justifies: [**45] (a) focusing on the directors' obligation to seek the best value reasonably available to the stockholders; and (b) requiring a close scrutiny of board action which could be contrary to the stockholders' interests.

Accordingly, when a corporation undertakes a transaction which will cause: (a) a change in corporate control; **or** (b) a break-up of the corporate entity, the directors' obligation is to seek the best value reasonably available to the stockholders. This obligation arises because the effect of the Viacom-Paramount transaction, if consummated, is to shift control of Paramount from the public stockholders to a controlling stockholder, Viacom. Neither *Time-Warner* nor any other decision of this Court holds that a "break-up" of the company is essential to give rise to this obligation where there is a sale of control.

III. BREACH OF FIDUCIARY DUTIES BY PARAMOUNT BOARD

We now turn to duties of the Paramount Board under the facts of this case and our conclusions as to the breaches of those duties which warrant injunctive relief.

A. The Specific Obligations of the Paramount Board

Under the facts of this case, the Paramount directors had the obligation: [**46] (a) to be diligent and vigilant in examining critically the Paramount-Viacom transaction and the QVC tender offers; (b) to act in good faith; (c) to obtain, and act with due care on, all material information reasonably available, including information necessary to compare the two offers to determine which of these transactions, or an alternative course of action, would provide the best value reasonably available to the stockholders; and (d) to negotiate actively and in good faith with both Viacom and QVC to that end.

Having decided to sell control of the corporation, the Paramount directors were required to evaluate critically whether or not all material aspects of the Paramount-Viacom transaction (separately and in the aggregate) were reasonable and in the best interests of the Paramount stockholders in light of current circumstances, including: the change of control premium, the Stock Option Agreement, the Termination Fee, the coercive nature of both the Viacom and QVC tender offers, [18] the No-Shop Provision, and the proposed disparate use of the Rights Agreement as to the Viacom and QVC tender offers, respectively.

18 Both the Viacom and the QVC tender offers were for 51 percent cash and a "back-end" of various securities, the value of each of which depended on the fluctuating value of Viacom and QVC stock at any given time. Thus, both tender offers were two-tiered, front-end loaded, and coercive. Such coercive offers are inherently problematic and should be expected to receive particularly careful analysis by a target board. *See*

Unocal, 493 A.2d at 956.

[**47] These obligations necessarily implicated various issues, including the questions of whether or not those provisions and other aspects of the Paramount-Viacom transaction (separately and in the aggregate): (a) adversely affected the value provided to the Paramount stockholders; (b) inhibited or encouraged alternative bids; (c) were enforceable contractual obligations in light of the directors' fiduciary duties; and (d) in the end would advance or retard the Paramount directors' obligation to secure for the Paramount stockholders the best value reasonably available under the circumstances.

The Paramount defendants contend that they were precluded by certain contractual provisions including the No-Shop Provision, from negotiating with QVC or seeking alternatives. Such provisions, whether or not they are presumptively valid in the abstract, may not validly define or limit the directors' fiduciary duties under Delaware law or prevent the Paramount directors from carrying out their fiduciary duties under Delaware law. To the extent such provisions are inconsistent with those duties, they are invalid and unenforceable. *See Revlon, 506 A.2d at 184-85.*

Since the Paramount directors [**48] had already decided to sell control, they had an obligation [*49] to continue their search for the best value reasonably available to the stockholders. This continuing obligation included the responsibility, at the October 24 board meeting and thereafter, to evaluate critically both the QVC tender offers and the Paramount-Viacom transaction to determine if: (a) the QVC tender offer was, or would continue to be, conditional; (b) the QVC tender offer could be improved; (c) the Viacom tender offer or other aspects of the Paramount-Viacom transaction could be improved; (d) each of the respective offers would be reasonably likely to come to closure, and under what circumstances; (e) other material information was reasonably available for consideration by the Paramount directors; (f) there were viable and realistic alternative courses of action; and (g) the timing constraints could be managed so the directors could consider these matters carefully and deliberately.

B. The Breaches of Fiduciary Duty by the Paramount Board

The Paramount directors made the decision on September 12, 1993, that, in their judgment, a strategic merger with Viacom on the economic terms of the Original [**49] Merger Agreement was in the best interests of Paramount and its stockholders. Those terms provided a modest change of control premium to the stockholders. The directors also decided at that time that it was appropriate to agree to certain defensive measures (the Stock Option Agreement, the Termination Fee, and the No-Shop Provision) insisted upon by Viacom as part of that economic transaction. Those defensive measures, coupled with the sale of control and subsequent disparate treatment of competing bidders, implicated the judicial scrutiny of *Unocal, Revlon, Macmillan,* and their progeny. We conclude that the Paramount directors' process was not reasonable, and the result achieved for the stockholders was not reasonable under the circumstances.

When entering into the Original Merger Agreement, and thereafter, the Paramount Board clearly gave insufficient attention to the potential consequences of the defensive measures demanded by Viacom. The Stock Option Agreement had a number of unusual and potentially "draconian" [19] provisions, including the Note Feature and the Put Feature. Furthermore, the Termination Fee, whether or not unreasonable by itself, clearly made Paramount less [**50] attractive to other bidders, when coupled with the Stock Option Agreement. Finally, the No-Shop Provision inhibited the Paramount Board's ability to negotiate with other potential bidders, particularly QVC which had already expressed an interest in Paramount. [20]

19 The Vice Chancellor so characterized the Stock Option Agreement. Court of Chancery Opinion, 635 A.2d at 1272. We express no opinion whether a stock option agreement of essentially this magnitude, but with a reasonable "cap" and without the Note and Put Features, would be valid or invalid under other circumstances. *See Hecco Ventures v. Sea-Land Corp., 1986 Del. Ch. LEXIS 421,* Del. Ch., C.A. No. 8486, Jacobs, V.C. (May 19, 1986) (21.7 percent stock option); *In re Vitalink Communications Corp. Shareholders Litig.,* Del. Ch., C.A. No. 12085, Chandler, V.C. (May 16, 1990) (19.9 percent stock option).

20 We express no opinion whether certain aspects of the No-Shop Provision here could be valid in another

context. Whether or not it could validly have operated here at an early stage solely to prevent Paramount from actively "shopping" the company, it could not prevent the Paramount directors from carrying out their fiduciary duties in considering unsolicited bids or in negotiating for the best value reasonably available to the stockholders. *Macmillan, 559 A.2d at 1287.* As we said in Barkan: "Where a board has no reasonable basis upon which to judge the adequacy of a contemplated transaction, a no-shop restriction gives rise to the inference that the board seeks to forestall competing bids." *567 A.2d at 1288. See also Revlon, 506 A.2d at 184* (holding that "the no-shop provision, like the lock-up option, while not *per se* illegal, is impermissible under the *Unocal* standards when a board's primary duty becomes that of an auctioneer responsible for selling the company to the highest bidder").

[**51] Throughout the applicable time period, and especially from the first QVC merger proposal on September 20 through the Paramount Board meeting on November 15, QVC's interest in Paramount provided the **opportunity** for the Paramount Board to seek significantly higher value for the Paramount stockholders than that being offered by Viacom. QVC persistently demonstrated its intention to meet and exceed the Viacom offers, and [*50] frequently expressed its willingness to negotiate possible further increases.

The Paramount directors had the opportunity in the October 23-24 time frame, when the Original Merger Agreement was renegotiated, to take appropriate action to modify the improper defensive measures as well as to improve the economic terms of the Paramount-Viacom transaction. Under the circumstances existing at that time, it should have been clear to the Paramount Board that the Stock Option Agreement, coupled with the Termination Fee and the No-Shop Clause, were impeding the realization of the best value reasonably available to the Paramount stockholders. Nevertheless, the Paramount Board made no effort to eliminate or modify these counterproductive devices, and instead continued [**52] to cling to its vision of a strategic alliance with Viacom. Moreover, based on advice from the Paramount management, the Paramount directors considered the QVC offer to be "conditional" and asserted that they were precluded by the No-Shop Provision from seeking more information from, or negotiating with, QVC.

By November 12, 1993, the value of the revised QVC offer on its face exceeded that of the Viacom offer by over $ 1 billion at then current values. This significant disparity of value cannot be justified on the basis of the directors' vision of future strategy, primarily because the change of control would supplant the authority of the current Paramount Board to continue to hold and implement their strategic vision in any meaningful way. Moreover, their uninformed process had deprived their strategic vision of much of its credibility. *See Van Gorkom, 488 A.2d at 872*; *Cede v. Technicolor, 634 A.2d at 367*; *Hanson Trust PLC v. ML SCM Acquisition Inc., 2d Cir., 781 F.2d 264, 274 (1986).*

When the Paramount directors met on November 15 to consider QVC's increased tender offer, they remained prisoners of their own misconceptions and missed opportunities to eliminate the [**53] restrictions they had imposed on themselves. Yet, it was not "too late" to reconsider negotiating with QVC. The circumstances existing on November 15 made it clear that the defensive measures, taken as a whole, were problematic: (a) the No-Shop Provision could not define or limit their fiduciary duties; (b) the Stock Option Agreement had become "draconian"; and (c) the Termination Fee, in context with all the circumstances, was similarly deterring the realization of possibly higher bids. Nevertheless, the Paramount directors remained paralyzed by their uninformed belief that the QVC offer was "illusory." This final opportunity to negotiate on the stockholders' behalf and to fulfill their obligation to seek the best value reasonably available was thereby squandered. [21]

21 The Paramount defendants argue that the Court of Chancery erred by assuming that the Rights Agreement was "pulled" at the November 15 meeting of the Paramount Board. The problem with this argument is that, under the Amended Merger Agreement and the resolutions of the Paramount Board related thereto, Viacom would be exempted from the Rights Agreement in the absence of further action of the Paramount Board and no further meeting had been scheduled or even contemplated prior to the closing of the Viacom tender offer. This failure to schedule and hold a meeting shortly before the closing date in order to make a final decision, based on all of the information and circumstances then existing, whether to exempt Viacom from the Rights Agreement

clear. In other cases they may be less clear. The holding of this case on its facts, coupled with the holdings of the principal cases discussed herein where the issue of sale of control is implicated, should provide a workable precedent against which to measure future cases.

For the reasons set forth herein, the November 24, [**58] 1993, Order of the Court of Chancery has been AFFIRMED, and this matter has been REMANDED for proceedings consistent herewith, as set forth in the December 9, 1993, Order of this Court.

ADDENDUM

The record in this case is extensive. The appendix filed in this Court comprises 15 volumes, totalling some 7251 pages. It includes [*52] substantial deposition testimony which forms part of the factual record before the Court of Chancery and before this Court. The members of this Court have read and considered the appendix, including the deposition testimony, in reaching its decision, preparing the Order of December 9, 1993, and this opinion. Likewise, the Vice Chancellor's opinion revealed that he was thoroughly familiar with the entire record, including the deposition testimony. As noted, *637 A.2d 34, 37*, note 2, the Court has commended the parties for their professionalism in conducting expedited discovery, assembling and organizing the record, and preparing and presenting very helpful briefs, a joint appendix, and oral argument.

The Court is constrained, however, to add this Addendum. Although this Addendum has no bearing on the outcome of the case, it relates to a serious [**59] issue of professionalism involving deposition practice in proceedings in Delaware trial courts. [23]

> 23 We raise this matter *sua sponte* as part of our exclusive supervisory responsibility to regulate and enforce appropriate conduct of lawyers appearing in Delaware proceedings. *See in re Infotechnology, Inc. Shareholder Litig., Del. Supr., 582 A.2d 215 (1990)*; *In re Nenno, Del. Supr., 472 A.2d 815, 819 (1983)*; *In re Green, Del. Supr., 464 A.2d 881, 885 (1983)*; *Delaware Optometric Corp. v. Sherwood, Del. Supr., 36 Del. Ch. 223, 128 A.2d 812 (1957)*; *Darling Apartment Co. v. Springer, Del. Supr., 25 Del. Ch. 420, 22 A.2d 397 (1941)*. Normally our supervision relates to the conduct of members of the Delaware Bar and those admitted *pro hac vice*. Our responsibility for supervision is not confined to lawyers who are members of the Delaware Bar and those admitted *pro hac vice*, however. *See In re Metviner*, Del. Supr., Misc. No. 256, Christie, C.J. (July 7, 1989 and Aug. 22, 1989) (ORDERS). Our concern, and our duty to insist on appropriate conduct in any Delaware proceeding, including out-of-state depositions taken in Delaware litigation, extends to all lawyers, litigants, witnesses, and others.

[**60] The issue of discovery abuse, including lack of civility and professional misconduct during depositions, is a matter of considerable concern to Delaware courts and courts around the nation. [24] One particular instance of misconduct during a deposition in this case demonstrates such an astonishing lack of professionalism and civility that it is worthy of special note here as a lesson for the future--a lesson of conduct not to be tolerated or repeated.

> 24 Justice Sandra Day O'Connor recently highlighted the national concern about the deterioration in civility in a speech delivered on December 14, 1993, to an American Bar Association group on "Civil Justice Improvements."
>
> > I believe that the justice system cannot function effectively when the professionals charged with administering it cannot even be polite to one another. Stress and frustration drive down productivity and make the process more time-consuming and expensive. Many of the best people get driven away from the field. The profession and the system itself lose esteem in the public's eyes.
> >
> > . . . .

was inconsistent with the Paramount Board's responsibilities and does not provide a basis to challenge the Court of Chancery's decision.

[**54] IV. VIACOM'S CLAIM OF VESTED CONTRACT RIGHTS

Viacom argues that it had certain "vested" contract rights with respect to the No-Shop Provision and the Stock Option Agreement. [22] In effect, Viacom's argument is that the Paramount directors could enter into an agreement in violation of their fiduciary duties and then render Paramount, and ultimately its stockholders, liable for failing to carry out an agreement in violation of those duties. Viacom's protestations about vested rights are without merit. This Court has found that those defensive measures were improperly designed to deter potential bidders, and that [*51] such measures do not meet the reasonableness test to which they must be subjected. They are consequently invalid and unenforceable under the facts of this case.

22 Presumably this argument would have included the Termination Fee had the Vice Chancellor invalidated that provision or if appellees had cross-appealed from the Vice Chancellor's refusal to invalidate that provision.

[**55] The No-Shop Provision could not validly define or limit the fiduciary duties of the Paramount directors. To the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable. *Cf. Wilmington Trust v. Coulter, 200 A.2d at 452-54.* Despite the arguments of Paramount and Viacom to the contrary, the Paramount directors could not contract away their fiduciary obligations. Since the No-Shop Provision was invalid, Viacom never had any vested contract rights in the provision.

As discussed previously, the Stock Option Agreement contained several "draconian" aspects, including the Note Feature and the Put Feature. While we have held that lock-up options are not *per se* illegal, *see Revlon, 506 A.2d at 183*, no options with similar features have ever been upheld by this Court. Under the circumstances of this case, the Stock Option Agreement clearly is invalid. Accordingly, Viacom never had any vested contract rights in that Agreement.

Viacom, a sophisticated party with experienced legal and financial advisors, knew of (and in fact demanded) the unreasonable [**56] features of the Stock Option Agreement. It cannot be now heard to argue that it obtained vested contract rights by negotiating and obtaining contractual provisions from a board acting in violation of its fiduciary duties. As the Nebraska Supreme Court said in rejecting a similar argument in *ConAgra, Inc. v. Cargill, Inc., Neb. Supr., 222 Neb. 136, 382 N.W.2d 576, 587-88 (1986)*, "To so hold, it would seem, would be to get the shareholders coming and going." Likewise, we reject Viacom's arguments and hold that its fate must rise or fall, and in this instance fall, with the determination that the actions of the Paramount Board were invalid.

V. CONCLUSION

The realization of the best value reasonably available to the stockholders became the Paramount directors' primary obligation under these facts in light of the change of control. That obligation was not satisfied, and the Paramount Board's process was deficient. The directors' initial hope and expectation for a strategic alliance with Viacom was allowed to dominate their decisionmaking process to the point where the arsenal of defensive measures established at the outset was perpetuated (not modified or eliminated) when [**57] the situation was dramatically altered. QVC's unsolicited bid presented the opportunity for significantly greater value for the stockholders and enhanced negotiating leverage for the directors. Rather than seizing those opportunities, the Paramount directors chose to wall themselves off from material information which was reasonably available and to hide behind the defensive measures as a rationalization for refusing to negotiate with QVC or seeking other alternatives. Their view of the strategic alliance likewise became an empty rationalization as the opportunities for higher value for the stockholders continued to develop.

It is the nature of the judicial process that we decide only the case before us--a case which, on its facts, is clearly controlled by established Delaware law. Here, the proposed change of control and the implications thereof were crystal

> . . . In my view, incivility disserves the client because it wastes time and energy--time that is billed to the client at hundreds of dollars an hour, and energy that is better spent working on the case than working over the opponent.

The Honorable Sandra Day O'Connor, "Civil Justice System Improvements," ABA at 5 (Dec. 14, 1993) (footnotes omitted).

[**61] On November 10, 1993, an expedited deposition of Paramount, through one of its directors, J. Hugh Liedtke, [25] was taken in the state of Texas. The deposition was taken by Delaware counsel for QVC. Mr. Liedtke was individually represented at this deposition by Joseph D. Jamail, Esquire, of the Texas Bar. Peter C. Thomas, Esquire, of the New York Bar appeared and defended on behalf of the Paramount defendants. It does not appear that any member of the Delaware bar was present at the deposition representing any of the defendants or the stockholder plaintiffs.

25 The docket entries in the Court of Chancery show a November 2, 1993, "Notice of Deposition of Paramount Board" (Dkt 65). Presumably, this included Mr. Liedtke, a director of Paramount. Under Ch. Ct. R. 32(a)(2), a deposition is admissible against a party if the deposition is of an officer, director, or managing agent. From the docket entries, it appears that depositions of third party witnesses (persons who were not directors or officers) were taken pursuant to the issuance of commissions.

[**62] Mr. Jamail did not otherwise appear in this Delaware proceeding representing any party, and he was not admitted *pro hac vice.* [26] [*53] Under the rules of the Court of Chancery and this Court, [27] lawyers who are admitted *pro hac vice* to represent a party in Delaware proceedings are subject to Delaware Disciplinary Rules, [28] and are required to review the Delaware State Bar Association Statement of Principles of Lawyer Conduct (the "Statement of Principles"). [29] During the Liedtke deposition, Mr. Jamail abused the privilege of representing a witness in a Delaware proceeding, in that he: (a) improperly directed the witness not to answer certain questions; (b) was extraordinarily rude, uncivil, and vulgar; and (c) obstructed the ability of the questioner to elicit testimony to assist the Court in this matter.

26 It does not appear from the docket entries that Mr. Thomas was admitted *pro hac vice* in the Court of Chancery. In fact, no member of his firm appears from the docket entries to have been so admitted until Barry R. Ostrager, Esquire, who presented the oral argument on behalf of the Paramount defendants, was admitted on the day of the argument before the Vice Chancellor, November 16, 1993.

[**63]

27 Ch. Ct. R. 170; Supr. Ct. R. 71. There was no Delaware lawyer and no lawyer admitted *pro hac vice* present at the deposition representing any party, except that Mr. Johnston, a Delaware lawyer, took the deposition on behalf of QVC. The Court is aware that the general practice has not been to view as a requirement that a Delaware lawyer or a lawyer already admitted *pro hac vice* must be present at all depositions. Although it is not as explicit as perhaps it should be, we believe that Ch. Ct. R. 170(d), fairly read, requires such presence:

> (d) Delaware counsel for any party shall appear in the action in which the motion for admission pro hac vice is filed and shall sign or receive service of all notices, orders, pleadings or other papers filed in the action, and shall attend all proceedings before the Court, Clerk of the Court, or other officers of the Court, unless excused by the Court. Attendance of Delaware Counsel at depositions shall not be required unless ordered by the Court.

See also Hoechst Celanese Corp. v. National Union Fire Ins. Co., Del. Super., 623 A.2d 1099, 1114 (1991). (Super. Ct. Civ. R. 90.1, which corresponds to Ch. Ct. R. 170, "merely excuses attendance of local counsel at depositions, but does not excuse non-Delaware counsel from compliance with the *pro hac vice* requirement. . . . A deposition conducted pursuant to Court rules is a proceeding."). We believe that these shortcomings in the enforcement of proper lawyer conduct can and should be remedied consistent with the nature of expedited proceedings.

[**64]

28 It appears that at least Rule 3.5(c) of the Delaware Lawyer's Rules of Professional Conduct is implicated here. It provides: "A lawyer shall not . . . (c) engage in conduct intended to disrupt a tribunal or engage in undignified or discourteous conduct which is degrading to a tribunal."

29 The following are a few pertinent excerpts from the Statement of Principles:

> The Delaware State Bar Association, for the Guidance of Delaware lawyers, **and those lawyers from other jurisdictions who may be associated with them,** adopted the following Statement of Principles of Lawyer Conduct on [November 15, 1991]. . . . The purpose of adopting these Principles is to promote and foster the ideals of **professional courtesy, conduct and cooperation.** . . . A lawyer should develop and maintain the qualities of integrity, compassion, learning, **civility,** diligence and public service that mark the most admired members of our profession. . . . [A] lawyer . . . **should treat** all persons, including **adverse lawyers** and parties, **fairly and equitably. . . . Professional civility is conduct that shows respect not only for the courts and colleagues, but also for all people encountered in practice.** . . . Respect for the court requires . . . emotional self-control; [and] the absence of scorn and superiority in words of demeanor. . . . A lawyer should use pre-trial procedures, including discovery, solely to develop a case for settlement or trial. **No pre-trial procedure should be used to harass an opponent or delay a case. . . . Questions and objections at deposition should be restricted to conduct appropriate in the presence of a judge.** . . . Before moving the admission of a lawyer from another jurisdiction, a Delaware lawyer should make such investigation as is required to form an informed conviction that the lawyer to be admitted is ethical and competent, and should furnish the candidate for admission with a copy of this Statement.

(Emphasis supplied.)

[**65] To illustrate, a few excerpts from the latter stages of the Liedtke deposition follow:

A. [Mr. Liedtke] I vaguely recall [Mr. Oresman's letter]. . . . I think I did read it, probably.

. . . .

Q. (By Mr. Johnston [Delaware counsel for QVC]) Okay. Do you have any idea why Mr. Oresman was calling that material to your attention?

MR. JAMAIL: Don't answer that.

How would he know what was going on in Mr. Oresman's mind?

Don't answer it.

Go on to your next question.

MR. JOHNSTON: No, Joe --

MR. JAMAIL: He's not going to answer that. Certify it. I'm going to shut it down if you don't go to your next question.

[*54] MR. JOHNSTON: No. Joe, Joe --

MR. JAMAIL: Don't "Joe" me, asshole. You can ask some questions, but get off of that. I'm tired of you. You could gag a maggot off a meat wagon. Now, we've helped you every way we can.

MR. JOHNSTON: Let's just take it easy.

MR. JAMAIL: No, we're not going to take it easy. Get done with this.

MR. JOHNSTON: We will go on to the next question.

MR. JAMAIL: Do it now.

MR. JOHNSTON: We will go on to the next question. We're not trying to excite anyone.

MR. JAMAIL: Come on. Quit talking. Ask the question. Nobody wants to socialize [**66] with you.

MR. JOHNSTON: I'm not trying to socialize. We'll go on to another question. We're continuing the deposition.

MR. JAMAIL: Well, go on and shut up.

MR. JOHNSTON: Are you finished?

MR. JAMAIL: Yeah, you --

MR. JOHNSTON: Are you finished?

MR. JAMAIL: I may be and you may be. Now, you want to sit here and talk to me, fine. This deposition is going to be over with. You don't know what you're doing. Obviously someone wrote out a long outline of stuff for you to ask. You have no concept of what you're doing.

Now, I've tolerated you for three hours. If you've got another question, get on with it. This is going to stop one hour from now, period. Go.

MR. JOHNSTON: Are you finished?

MR. THOMAS: Come on, Mr. Johnston, move it.

MR. JOHNSTON: I don't need this kind of abuse.

MR. THOMAS: Then just ask the next question.

Q. (By Mr. Johnston) All right. To try to move forward, Mr. Liedtke, . . . I'll show you what's been marked as Liedtke 14 and it is a covering letter dated October 29 from Steven Cohen of Wachtell, Lipton, Rosen & Katz including QVC's Amendment Number 1 to its Schedule 14D-1, and my question --

A. No.

Q. -- to you, sir, is whether you've seen that?

A. No. Look, [**67] I don't know what your intent in asking all these questions is, but, my God, I am not going to play boy lawyer.

Q. Mr. Liedtke --

A. Okay. Go ahead and ask your question.

Q. -- I'm trying to move forward in this deposition that we are entitled to take. I'm trying to streamline it.

MR. JAMAIL: Come on with your next question. Don't even talk with this witness.

MR. JOHNSTON: I'm trying to move forward with it.

MR. JAMAIL: You understand me? Don't talk to this witness except by question. Did you hear me?

MR. JOHNSTON: I heard you fine.

MR. JAMAIL: You fee makers think you can come here and sit in somebody's office, get your meter running, get your full day's fee by asking stupid questions. Let's go with it.

(JA 6002-06). [30]

30 Joint Appendix of the parties on appeal.

Staunch advocacy on behalf of a client is proper and fully consistent with the finest effectuation of skill and professionalism. Indeed, it is a mark of professionalism, not weakness, for a lawyer zealously and firmly to protect [**68] and pursue a client's legitimate interests by a professional, courteous, and civil attitude toward all persons involved in the litigation process. A lawyer who engages in the type of behavior exemplified by Mr. Jamail on the record of the Liedtke deposition is not properly representing his client, and the client's cause is not advanced by a lawyer who engages in unprofessional conduct of this nature. It happens that in this case there was no application to the Court, and the parties and the witness do not [*55] appear to have been prejudiced by this misconduct. [31]

31 We recognize the practicalities of litigation practice in our trial courts, particularly in expedited proceedings such as this preliminary injunction motion, where simultaneous depositions are often taken in far-flung locations, and counsel have only a few hours to question each witness. Understandably, counsel may be reluctant to take the time to stop a deposition and call the trial judge for relief. Trial courts are extremely busy and overburdened. Avoidance of this kind of misconduct is essential. If such misconduct should occur, the aggrieved party should recess the deposition and engage in a dialogue with the offending lawyer to obviate the need to call the trial judge. If all else fails and it is necessary to call the trial judge, sanctions may be appropriate against the offending lawyer or party, or against the complaining lawyer or party if the request for court relief is unjustified. *See* Ch. Ct. R. 37. It should also be noted that discovery abuse sometimes is the fault of the questioner, not the lawyer defending the deposition. These admonitions should be read as applying to both sides.

[**69] Nevertheless, the Court finds this unprofessional behavior to be outrageous and unacceptable. If a Delaware lawyer had engaged in the kind of misconduct committed by Mr. Jamail on this record, that lawyer would have been subject to censure or more serious sanctions. [32] While the specter of disciplinary proceedings should not be used by the parties as a litigation tactic, [33] conduct such as that involved here goes to the heart of the trial court proceedings themselves. As such, it cries out for relief under the trial court's rules, including Ch. Ct. R. 37. Under some circumstances, the use of the trial court's inherent summary contempt powers may be appropriate. *See In re Butler, Del. Supr., 609 A.2d 1080, 1082 (1992).*

32 *See In re Ramunno, Del. Supr., 625 A.2d 248, 250 (1993)* (Delaware lawyer held to have violated Rule 3.5 of the Rules of Professional Conduct, and therefore subject to public reprimand and warning for use of profanity similar to that involved here and "insulting conduct toward opposing counsel [found] . . . unacceptable by any standard").
33 *See Infotechnology, 582 A.2d at 220* ("In Delaware there is the fundamental constitutional principle that [the Supreme] Court, alone, has the sole and exclusive responsibility over all matters affecting governance of the Bar. . . . The Rules are to be enforced by a disciplinary agency, and are not to be subverted as procedural

weapons.").

[**70] Although busy and overburdened, Delaware trial courts are "but a phone call away" and would be responsive to the plight of a party and its counsel bearing the brunt of such misconduct. [34] It is not appropriate for this Court to prescribe in the abstract any particular remedy or to provide an exclusive list of remedies under such circumstances. We assume that the trial courts of this State would consider protective orders and the sanctions permitted by the discovery rules. Sanctions could include exclusion of obstreperous counsel from attending the deposition (whether or not he or she has been admitted *pro hac vice),* ordering the deposition recessed and reconvened promptly in Delaware, or the appointment of a master to preside at the deposition. Costs and counsel fees should follow.

34 *See Hall v. Clifton Precision, E.D. Pa., 150 F.R.D. 525 (1993)* (ruling on "coaching," conferences between deposed witnesses and their lawyers, and obstructive tactics):

> Depositions are the factual battleground where the vast majority of litigation actually takes place. . . . Thus, it is particularly important that this discovery device not be abused. Counsel should never forget that even though the deposition may be taking place far from a real courtroom, with no black-robed overseer peering down upon them, as long as the deposition is conducted under the caption of this court and proceeding under the authority of the rules of this court, counsel are operating as officers of this court. They should comport themselves accordingly; should they be tempted to stray, they should remember that this judge is but a phone call away.

150 F.R.D. at 531.

[**71] As noted, this was a deposition of Paramount through one of its directors. Mr. Liedtke was a Paramount witness in every respect. He was not there either as an individual defendant or as a third party witness. Pursuant to Ch. Ct. R. 170(d), the Paramount defendants should have been represented at the deposition by a Delaware lawyer or a lawyer admitted *pro hac vice.* A Delaware lawyer who moves the admission *pro hac vice* of an out-of-state lawyer is not relieved of responsibility, is required to appear at all court proceedings (except depositions when a lawyer admitted *pro hac vice* is present), shall certify that the lawyer appearing [*56] *pro hac vice* is reputable and competent, and that the Delaware lawyer is in a position to recommend the out-of-state lawyer. [35] Thus, one of the principal purposes of the *pro hac vice* rules is to assure that, if a Delaware lawyer is not to be present at a deposition, the lawyer admitted *pro hac vice* will be there. As such, he is an officer of the Delaware Court, subject to control of the Court to ensure the integrity of the proceeding.

35 *See, e.g.,* Ch. Ct. R. 170(b), (d), and (h).

[**72] Counsel attending the Liedtke deposition on behalf of the Paramount defendants had an obligation to ensure the integrity of that proceeding. The record of the deposition as a whole (JA 5916-6054) demonstrates that, not only Mr. Jamail, but also Mr. Thomas (representing the Paramount defendants), continually interrupted the questioning, engaged in colloquies and objections which sometimes suggested answers to questions, [36] and constantly pressed the questioner for time throughout the deposition. [37] As to Mr. Jamail's tactics quoted above, Mr. Thomas passively let matters proceed as they did, and at times even added his own voice to support the behavior of Mr. Jamail. A Delaware lawyer or a lawyer admitted *pro hac vice* would have been expected to put an end to the misconduct in the Liedtke deposition.

36 Rule 30(d)(1) of the revised Federal Rules of Civil Procedure, which became effective on December 1, 1993, requires objections during depositions to be "stated concisely and in a non-argumentative and non-suggestive manner." *See Hall, 150 F.R.D. at 530. See also Rose Hall, Ltd. v. Chase Manhattan Overseas Banking Corp.* D. Del., C.A. No. 79-182, Steel, J. (Dec. 12, 1980); *Cascella v. GDV, Inc., 1981 Del. Ch. LEXIS 455,* Del. Ch., C.A. No. 5899, Brown, V.C. (Jan. 15, 1981); *In re Asbestos Litig., Del. Super., 492 A.2d 256*

(1985); *Deutschman v. Beneficial Corp.*, Del. Del., C.A. No. 86-595 MMS, Schwartz, J. (Feb. 20, 1990). The Delaware trial courts and this Court are evaluating the desirability of adopting certain of the new Federal Rules, or modifications thereof, and other possible rule changes.

[**73]

37 While we do not necessarily endorse everything set forth in the *Hall* case, we share Judge Gawthrop's view not only of the impropriety of coaching witnesses on and off the record of the deposition *(see supra* note 34), but also the impropriety of objections and colloquy which "tend to disrupt the question-and-answer rhythm of a deposition and obstruct the witness's testimony." *See 150 F.R.D. at 530*. To be sure, there are also occasions when the questioner is abusive or otherwise acts improperly and should be sanctioned. *See supra* note 31. Although the questioning in the Liedtke deposition could have proceeded more crisply, this was not a case where it was the questioner who abused the process.

This kind of misconduct is not to be tolerated in any Delaware court proceeding, including depositions taken in other states in which witnesses appear represented by their own counsel other than counsel for a party in the proceeding. Yet, there is no clear mechanism for this Court to deal with this matter in terms of sanctions or disciplinary remedies at this time in the context of this [**74] case. Nevertheless, consideration will be given to the following issues for the future: (a) whether or not it is appropriate and fair to take into account the behavior of Mr. Jamail in this case in the event application is made by him in the future to appear *pro hac vice* in any Delaware proceeding; [38] and (b) what rules or standards should be adopted to deal effectively with misconduct by out-of-state lawyers in depositions in proceedings pending in Delaware courts.

38 The Court does not condone the conduct of Mr. Thomas in this deposition. Although the Court does not view his conduct with the gravity and revulsion with which it views Mr. Jamail's conduct, in the future the Court expects that counsel in Mr. Thomas's position will have been admitted *pro hac vice* before participating in a deposition. As an officer of the Delaware Court, counsel admitted *pro hac vice* are now clearly on notice that they are expected to put an end to conduct such as that perpetrated by Mr. Jamail on this record.

As [**75] to (a), this Court will welcome a voluntary appearance by Mr. Jamail if a request is received from him by the Clerk of this Court within thirty days of the date of this Opinion and Addendum. The purpose of such voluntary appearance will be to explain the questioned conduct and to show cause why such conduct should not be considered as a bar to any future appearance by Mr. Jamail in a Delaware proceeding. As to (b), this Court and the trial courts of this State will undertake to strengthen the existing mechanisms for dealing with the type of misconduct referred [*57] to in this Addendum and the practices relating to admissions *pro hac vice*.

TAB "14"

H
UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Court of Chancery of Delaware.
UNISUPER LTD., Public Sector Superannuation Scheme Board, Commonwealth Superannuation Scheme Board, United Super Pty Ltd., Motor Trades Association of Australia Superannuation Fund Pty Ltd., H.E.S.T. Australia Ltd., Care Super Pty Ltd., Universities Superannuation Scheme Ltd., Britel Fund Nominees Limited, Hermes Assured Limited, Stichting Pensioenfonds ABP, Connecticut Retirement Plans and Trust Funds, and the Clinton Township Police and Fire Retirement System, Plaintiffs,
v.
NEWS CORPORATION, a Delaware corporation, K. Rupert Murdoch AC, Peter L. Barnes, Chase Carey, Peter Chernin, Kenneth E. Cowley AO, David F. Devoe, Viet Dinh, Roderick Eddington, Andrew S.B. Knight, Lachlan K. Murdoch, Thomas J. Perkins, Stanley S. Shuman, Arthur M. Siskind, and John L. Thornton,
Defendants.
No. 1699-N.

Submitted Nov. 7, 2005.
Decided Dec. 20, 2005.

Stuart M. Grant, Megan D. McIntyre and Cynthia A. Calder, of Grant & Eisenhofer P.A., Wilmington, Delaware, for Plaintiffs.

Edward P. Welch, Robert S. Saunders, Edward B. Micheletti and T. Victor Clark, of Skadden, ARPS, Slate, Meagher & Flom LLP, Wilmington, Delaware, for Defendants.

MEMORANDUM OPINION
CHANDLER, J.

*1 This case arises from a dispute between institutional shareholders and a company whose shares the investors owned and whose corporate governance they were monitoring. Plaintiffs filed this action on October 7, 2005, against defendant News Corporation ("News Corp." or "the Company") seeking to invalidate News Corp.'s extension of its poison pill and to prohibit any further extensions absent shareholder approval. Plaintiffs allege that News Corp. contracted, or else promised, that any extension of its poison pill would be put to a shareholder vote. When News Corp.'s board of directors extended the pill without a shareholder vote, plaintiffs filed this lawsuit. The individuals who were directors of News Corp. at the relevant times have also been named as defendants. [FN1] Defendants have filed a motion to dismiss. For the reasons set forth below, I deny defendants' motion on counts I and II, and I grant defendants' motion on counts III, IV and V.

FN1. The Individual or Director defendants are: K. Rupert Murdoch, Peter L. Barnes, Chase Carey, Peter Chernin, Kenneth E. Cowley, David Devoe, Viet Dinh, Roderick Eddington, Andrew S.B. Knight, Lachlan K. Murdoch, Thomas J. Perkins, Stanley S. Shuman, Arthur M. Siskind, and John L. Thornton.

I. BACKGROUND

On April 6, 2004, News Corp. issued a press release announcing a plan of reorganization that would include the reincorporation of News Corp.--then an Australian corporation--as a Delaware corporation. [FN2] The reorganization would be contingent on a shareholder vote of approval by each class of News Corp.'s shareholders voting separately. [FN3] Because the shares beneficially owned by the Murdoch family voted as their own class, the public shareholders were in a position to prevent the reorganization if they voted as a class to reject it.

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FN2. Compl. ¶ 33.

FN3. Compl. ¶ 34.

In late July 2004, the Australian Council of Super Investors Inc. ("ACSI") and Corporate Governance International ("CGI") met with News Corp. to discuss the reincorporation proposal. ACSI is a non-profit organization that advises Australian pension funds on corporate governance and CGI is an Australian proxy advisory firm. [FN4] During these meetings, ACSI and CGI informed News Corp. of their concerns about the reincorporation's impact on shareholder rights and other corporate governance issues. [FN5] One of the specific concerns mentioned by ACSI and GCI was that, under Delaware law, the Company's board of directors would be able to institute a poison pill without shareholder approval, while under Australian law shareholder approval is required. [FN6]

FN4. Compl. ¶ 31.

FN5. Compl. ¶ 37.

FN6. Compl. ¶ 42.

After these meetings, ACSI and CGI began to develop a set of proposed changes to News Corp.'s post-reorganization, Delaware certificate of incorporation. ACSI and CGI drafted these proposed changes in the form of a "Governance Article." The Governance Article contained several provisions, including one providing that "the Board shall not have the power to, and shall not, create or implement any device, matter, or thing the purpose, nature, or effect of which is commonly described as a 'poison pill.' " [FN7] On August 20, 2004, ACSI sent a copy of the Governance Article to News Corp. and requested that the proposals be included in the charter of the new Delaware corporation. [FN8]

FN7. Compl. ¶ 39.

FN8. Compl. ¶ 40.

*2 In late September 2004, News Corp. informed ACSI that the changes to the certificate of incorporation set forth in the Governance Article would not be adopted and that there would be no further negotiations. In response, ACSI issued a press release on September 27, 2004, recounting the negotiations with News Corp. and expressing ACSI's belief that the proposed reincorporation would result in the loss of shareholder protections. [FN9] ACSI's September 27, 2004, press release was widely circulated and had the effect of galvanizing institutional investor opposition to the reincorporation . [FN10]

FN9. Compl. ¶ 43.

FN10. Compl. ¶ 44.

On October 1, 2004, News Corp. reversed itself and initiated further negotiations with ACSI. The General Counsel for News Corp., Ian Phillip, contacted the President of ACSI, Michael O'Sullivan, and told O'Sullivan that further negotiations were possible. At this stage of the negotiations, five key issues relating to News Corp.'s corporate governance remained in contention. [FN11] Three of these issues would be dealt with through the adoption of binding provisions in the new, Delaware certificate of incorporation. Only the poison pill voting issue would be dealt with through the adoption of a so-called "board policy."

FN11. Compl. ¶ 45.

The first issue was whether News Corp. would agree to retain its full foreign listing on the Australian Stock Exchange. [FN12] News Corp. ultimately agreed that its Delaware certificate of incorporation would include a provision requiring that News Corp. retain its full listing on the Australian Stock Exchange. [FN13] The second issue was whether News Corp. would agree to insert a provision into its Delaware certificate of incorporation stating that News Corp. would not issue new shares having more than one vote per share. [FN14] The parties ultimately agreed that such a provision

would be added to the new certificate of incorporation. [FN15] With respect to the third issue, the parties agreed to add a provision to the certificate of incorporation providing that holders of 20 percent or more of the outstanding voting shares of News Corp. could cause a special meeting of shareholders to be called. [FN16] The fourth issue was dealt with through a series of voting agreements entered into by Rupert Murdoch. [FN17] These agreements provided that Murdoch would not sell any of his voting shares to a purchaser if, following such sale, the purchaser would own more than 19.9 percent of News Corp., unless such purchaser agreed to purchase all the voting and non-voting shares of News Corp. [FN18] Murdoch further agreed that these voting agreements could not be terminated or amended without the affirmative vote of News Corp.'s shareholders, excluding Murdoch and his affiliates. [FN19] The fifth and final of the key issues was News Corp.'s ability under Delaware law to adopt a poison pill without a shareholder vote. [FN20]

FN12. Compl. ¶ 48. (Stating that the parties "reached a final agreement on all five areas of concern. The terms of that agreement were announced in [the October 6 Press Release.]") *See also* Pls .' Answering Br. Ex. C.

FN13. Pls.' Answering Br. Ex. C.

FN14. *Id.*

FN15. *Id.*

FN16. *Id.*

FN17. *Id.*

FN18. *Id.*

FN19. *Id.*

FN20. *Id.*

During the negotiations on the fifth issue, ACSI again sought an amendment to the Company's Delaware certificate of incorporation that would require a shareholder vote approving the adoption of a poison pill. [FN21] In response to this request, Phillip told O'Sullivan that an amendment to the certificate of incorporation was impractical because there was not enough time. [FN22] Time was limited because of the need to hold the shareholder vote as well as the need to have the reincorporation approved by an Australian court, as required by Australian corporate law. Phillip told O'Sullivan that, in the limited time remaining, it would be too difficult to draft and finalize an amendment to the certificate of incorporation that would encompass everything that might fall within the definition of "poison pill." [FN23]

FN21. Compl. ¶ 46.

FN22. *Id.*

FN23. *Id.*

*3 Plaintiffs allege that during these conversations between ACSI and News Corp., someone on behalf of News Corp. proposed that, rather than instituting an amendment to the certificate of incorporation, the poison pill issue be addressed by means of the adoption of a board policy (the "Board Policy"). [FN24] Plaintiffs allege that someone, on behalf of News Corp., further agreed that News Corp.'s board would not circumvent the voting requirement by "rolling over" a poison pill for successive one-year terms on substantially similar terms and conditions or to the same effect without shareholder approval. [FN25]

FN24. Compl. ¶ 47.

FN25. *Id.*

On October 6, 2004, the terms of the agreement were announced in a News Corp. press release. The press release stated:

> The [News Corp.] Board has adopted a policy that if a shareholder rights plan is adopted by the Company following reincorporation, the plan

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would have a one-year sunset clause unless shareholder approval is obtained for an extension. The policy also provides that if shareholder approval is not obtained, the Company will not adopt a successor shareholder rights plan having substantially the same terms and conditions. [FN26]

FN26. Compl. ¶ 48.

On October 7, 2004, Phillip emailed the "agreed deal points" to ACSI reiterating that it was the board's policy to hold a shareholder vote on twelve-month old poison pills. [FN27] Also on October 7, 2004, News Corp. sent a letter to all of its shareholders and option-holders stating:

FN27. Compl. ¶ 49.

> [T]he board ... has established a policy that if any stockholder rights plan (known as a 'poison pill') is adopted without stockholder approval, it will expire after one year unless it is ratified by stockholders. This policy will not permit the plan to be rolled over for successive one-year terms on substantially the same terms and conditions or to the same effect without stockholder ratification. [FN28]

FN28. Compl. ¶ 51.

On October 26, 2004, the shareholders and options-holders of News Corp. voted to approve the reorganization. The plaintiffs voted in favor of the reorganization and did not appear in court to object to the reorganization.

On November 8, 2004, Liberty Media Corporation ("Liberty Media") suddenly appeared as a potential hostile acquiror for News Corp. [FN29] Liberty Media announced it had entered into an arrangement with a third party allowing it to acquire an additional 8% of News Corp.'s voting stock, thereby increasing its ownership to more than 17% of the voting stock. [FN30] In response to this threat, News Corp.'s board adopted a poison pill, which it announced in a November 8, 2004 press release. [FN31] In this press release, the board also announced that, going forward, it might or might not implement the Board Policy depending on whether it deemed the policy "appropriate in light of the facts and circumstances existing at such time." [FN32] One year later, on November 8, 2005, the board extended the poison pill without a shareholder vote, in contravention of the Board Policy.

FN29. Compl. ¶ 58.

FN30. *Id.*

FN31. Compl. ¶ 59.

FN32. Compl. ¶ 60. By the time of the November 8, 2004 press release, plaintiffs had already cast their votes in favor of the reincorporation.

Plaintiffs, a group of Australian institutional investors, [FN33] filed their complaint on October 7, 2005. [FN34] The complaint contains five counts. Count I is for breach of contract. Count II asserts a claim for promissory estoppel. Count III is a claim for fraud. Count IV is a claim for negligent misrepresentation and equitable fraud. Count V is a claim for breach of fiduciary duties against the individual defendants. As relief for these claims, plaintiffs seek a judgment declaring the Company's poison pill invalid and enjoining defendants from extending the pill without first obtaining approval from the Company's shareholders. [FN35]

FN33. The plaintiffs are: UniSuper Ltd., Public Sector Superannuation Scheme Board, Commonwealth Superannuation Scheme Board, United Super Pty. Ltd., Motor Trades Association of Australia Superannuation Fund Pty. Ltd., H.E.S.T. Australia Ltd., CARE Super Pty. Ltd., Universities Superannuation Scheme Limited, Britel Fund Nominees Limited, Stichting Pensioenfonds ABP, Connecticut Retirement Plans and Trust Funds, and Clinton Township Police and Fire Retirement Sys-

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tem.

FN34. Plaintiffs allege that the board's ultimate decision to extend the poison pill was foreshadowed in early August 2005. On August 10, the Company's Form 8-K filing indicated that the poison pill would be extended for two years beyond its November 8, 2005 expiration date, without shareholder approval. The 8-K made no mention of the Board Policy or explained why it would not be followed. The plaintiffs also were aware of an article published by the CEO of News Limited on August 20, 2005, that explained the board's action as follows:

The company said it would establish a policy which it did. The company did not claim to anyone at any time, verbally or in writing, that it would never change the policy. No agreement was breached, no promise was broken and there is no credible evidence to the contrary.

Plaintiffs allege that this statement betrays the illusory nature of the Board Policy. Had plaintiffs been aware of the fact that the board never intended to honor the Policy, they allege that they would have voted against the reorganization. Compl. ¶ 66.

FN35. The Court earlier refused plaintiffs' request to schedule an expedited injunction hearing, concluding that it could afford plaintiffs' full relief even after the poison pill had been extended by requiring defendants to withdraw it.

II. ANALYSIS

A. Standard on a Motion to Dismiss

*4 To survive a motion to dismiss, a complaint must allege facts that, if true, would establish the elements of a claim. [FN36] When considering a motion to dismiss under Rule 12(b)(6), I am required to assume the truthfulness of all well-pleaded allegations of the complaint. In addition, I am required to extend to plaintiffs the benefit of all reasonable inferences that can be drawn from the complaint. Conclusory statements without supporting factual averments will not be accepted as true for purposes of this motion. [FN37] Using this standard, I cannot order a dismissal unless it is reasonably certain that the plaintiffs could not prevail under any set of facts that can be inferred from the complaint.

FN36. *See, e.g., Lewis v. Honeywell, Inc.,* 1987 WL 14747, at *4 (Del. Ch. July 28, 1987).

FN37. *Grimes v. Donald,* 673 A.2d 1207, 1214 (Del.1996).

With regard to plaintiffs' fraud claims, I apply the heightened pleading standard of Rule 9(b). Plaintiffs are required to plead particular facts of a fraud claim, *i.e.,* the pleading must identify the "time, place, and contents of the false misrepresentations, the facts misrepresented, as well as the identity of the person making the misrepresentation and what he obtained thereby." [FN38]

FN38. *York Linings v. Roach,* 1999 WL 608850, at *2 (Del. Ch. July 28, 1999) (internal quotations and citations omitted); *Metro Commc'ns Corp. BVI v. Advanced Mobilecomm Tech.,* 854 A.2d 121, 144 (Del. Ch.2004).

B. Count I--Breach of Contract

Plaintiffs' allege that defendants entered into a contract when plaintiffs agreed to vote in favor of News Corp.'s reorganization in consideration for News Corp.'s promise to submit any extensions of its poison pill to a shareholder vote. This contract allegedly provided that News Corp. would adopt a board policy and that the board policy would not be revocable. [FN39] Plaintiffs assert two legal theories for how the contract was formed. The first theory is that the parties entered into a written contract

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evidenced by the Press Release and the Letter to Shareholders. The second is that the parties entered into an oral agreement. The complaint asserts very few facts to support either of these theories. Because I am required to draw each crucial inference in plaintiffs' favor, however, I conclude that plaintiffs' breach of contract claim survives defendants' motion to dismiss.

> FN39. One aspect of plaintiffs' contract theory strikes me as problematic: Plaintiffs are sophisticated investors capable of negotiating enforceable agreements to protect their interests, as is demonstrated in this case by the certificate of incorporation amendments plaintiffs managed to extract from defendants. Of the five key issues that the parties negotiated over, three were dealt with through amendments to the certificate of incorporation, and another was specifically made binding absent a shareholder vote. Thus, it is not entirely clear why in this instance plaintiffs accepted a promise to adopt a board policy, which is a more transitory right than a charter provision, especially when sophisticated parties such as these must have understood the significant difference between a charter provision and a board policy. Nonetheless, assuming every reasonable inference in plaintiffs' favor, I cannot say at this stage that there is no set of facts that would entitle plaintiffs to prevail on their contract theory. Although plaintiffs' claim is sufficient to withstand a motion to dismiss because of the liberal standard applied in this context, it will be plaintiffs' burden going forward to demonstrate a factual and legal basis for this claim.

i. Allegations of a Written Agreement: The Press Release and Letter to Shareholders

Defendants concede there was an agreement embodied in the Press Release and Letter to Shareholders by which News Corp. promised to adopt a board policy. They argue that the parties never discussed making the policy irrevocable and that, under Delaware law, a board policy is non-binding and revocable by the board at any time. [FN40] Plaintiffs counter that the contract in this case contemplated that the board would not be able to "roll over" the pill, *i.e.*, circumvent the shareholder vote by rescinding the Board Policy.

> FN40. Defs.' Opening Br. at 14.

Defendants are correct that board policies, like board resolutions, are typically revocable by the board at will. They cite *In re General Motors (Hughes) Shareholders Litigation* [FN41] in support of the proposition that board policies are always revocable, in every circumstance. The board in *General Motors* adopted a "Board Policy Statement" setting forth procedures to be followed in the event of a material transaction between General Motors ("GM") and one of its subsidiaries, Hughes Electronics Corporation ("Hughes"). The policy required that in the event of a transfer of material assets from Hughes to GM, the GM board would be required to declare and pay a dividend to the Hughes shareholders.

> FN41. 2005 WL 1089021 (Del. Ch. May 4, 2005)

*5 In *General Motors,* this Court stated in a footnote that *if* a board policy has the effect of a board resolution, it *might* be revocable by the board at any time. [FN42] This statement was phrased as a conditional statement because, as the Court noted, the complaint in *General Motors* contained no information with respect to the extent to which the GM board was bound to protect the rights granted to shareholders by the policy statement, *i.e.*, the extent to which the policy had an effect greater than a simple board resolution. In contrast, *the complaint in this case alleges that the News Corp. board was contractually bound to protect the rights granted by the Board Policy.* Plaintiffs allegation is precisely that, in contrast to the facts in *General Motors,* the Board Policy in this case had an effect *greater* than

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that of a resolution because the board was contractually bound to keep it in place.

FN42. *In re General Motors (Hughes) S'holder Litig.*, 2005 WL 1089021 at n. 34 (the footnote states, in part:
As opposed to the rights ... set out in GM's Restated Certificate of Incorporation, which is binding upon the GM board, *there is no information* in the Complaint with respect to the extent to which the GM board was bound to protect the rights ... granted by the Policy Statement. *If* the Policy Statement had *the effect* of a resolution adopted by the board, it *presumably* could be rescinded or amended by nothing more than another board resolution. (Emphasis added.))

This Court's statement about board policies in *General Motors* simply reiterates an elementary principle of corporate law: If the board has the power to adopt resolutions (or policies), then the power to rescind resolutions (policies) must reside with the board as well. An equally strong principle is that: If a board enters into a contract to adopt and keep in place a resolution (or a policy) that others justifiably rely upon to their detriment, that contract may be enforceable, without regard to whether resolutions (or policies) are typically revocable by the board at will.

On their face, the Press Release and the Letter to Shareholders state that the News Corp. board would adopt a board policy. If the Press Release and the Letter to Shareholders stated nothing more, I would be inclined to grant Defendants' motion with respect to the allegations of a written contract. But both the Press Release and the Letter to Shareholders go on to state that the board policy will not permit the pill to be rolled over. The plaintiffs are entitled to all reasonable inferences, including the inference that this part of the agreement expresses an intent that the Board Policy would not be rescinded before the shareholders had a chance to vote. On this point, the meaning of the contract is ambiguous and both sides should have the opportunity to present evidence and make legal arguments concerning the proper interpretation of the agreement. [FN43] Whether plaintiffs will be able to adduce evidence in support of their allegations is for another day. But for now, it is sufficient that they have alleged the existence of an agreement, the existence of valuable consideration (their vote in favor of the reorganization), and that the board intentionally breached the agreement.

FN43. There are other ambiguities inherent in the alleged agreement. For example, what is the term or duration of the Board Policy? Did the parties intend to preclude the board from *ever* modifying the Board Policy? If the shareholders voted not to extend the poison pill, would a future board of News Corp. also be disabled from adopting a poison pill? If plaintiffs are correct about the alleged agreement, then how could the agreement have left out these crucial details?

ii. Allegations of an Oral Contract

The complaint avers facts barely sufficient to state a claim that defendants made an oral contract with the shareholders during these conversations. The details of the alleged oral contract are not spelled out in the complaint, but what is clear is that the key term of the alleged oral contract was that shareholders would get to vote on any extension of a poison pill.

***6** The operative sections of the complaint are paragraphs 46 and 47. The complaint makes reference to the conversations between Phillip and O'Sullivan and sets forth general facts about those conversations. Notwithstanding the dearth of factual detail about the oral contract, Rule 12(b) sets forth a "notice pleading" standard and I conclude that the complaint gives adequate notice, if barely so, as to when the alleged oral agreement was formed and as to its contents. Many of the ambiguities and gaps in the written agreement also infect the alleged oral

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agreement, if not more so. Nevertheless, at this early stage of the lawsuit, I must deny defendants' motion to dismiss plaintiffs' claim of an oral contract.

iii. Unenforceability

Defendants assert that, even if plaintiffs are right about the existence, substance and interpretation of the alleged contract, the contract is unenforceable as a matter of law. [FN44] Defendants offer two arguments in support of this proposition.

FN44. Defs.' Reply Br. at 14.

a. Section 141(a)

Defendants first argue the alleged agreement is inconsistent with the general grant of managerial authority to the board in Section 141(a) of the Delaware General Corporation Law. [FN45] According to defendants, Section 141(a) vests power to manage the corporation in the board of directors and requires that any limitation on this power be in the certificate of incorporation. Defendants contend that an agreement to hold a shareholder vote on poison pills (or any other issue affecting the business and affairs of the corporation) is unenforceable unless memorialized in the certificate of incorporation.

FN45. Section 141(a) states:
The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.

By definition, any contract a board could enter into binds the board and thereby limits its power. Section 141(a) does not say the board cannot enter into contracts. It simply describes who will manage the affairs of the corporation and it precludes a board of directors from ceding that power to outside groups or individuals.

The fact that the alleged contract in this case gives power to the shareholders saves it from invalidation under Section 141(a). The alleged contract with ACSI did not cede power over poison pills to an outside group; rather, it ceded that power to shareholders. [FN46] In effect, defendants' argument is that the board impermissibly ceded power *to the shareholders*. Defendants' argument is that the contract impermissibly restricted the board's power by granting *shareholders* an irrevocable veto right over a question of corporate control. [FN47]

FN46. The contract required that the pill be put to a shareholder vote on a date twelve months after the pill's adoption. On that date, the shareholders would exercise their power either to approve or to reject the pill.

FN47. Defs.' Reply Br. at 15.

Delaware's corporation law vests managerial power in the board of directors because it is not feasible for shareholders, the owners of the corporation, to exercise day-to-day power over the company's business and affairs. [FN48] Nonetheless, when shareholders exercise their right to vote in order to assert control over the business and affairs of the corporation the board must give way. This is because the board's power--which is that of an agent's with regard to its principal--derives from the shareholders, who are the ultimate holders of power under Delaware law. [FN49]

FN48. Of course, the board of directors' managerial power is not unlimited; it is constrained by the directors' fiduciary duties and by shareholders' right to vote. The Delaware General Corporation Law gives shareholders an immutable right to vote on fundamental corporate changes. *See, e.g.*, 8 *Del. C.* § 242 (charter amendment); § 251 (merger); § 271 (sale of assets); § 275 (dissolution). In addition, the Delaware General Corporation Law vests shareholders with the power to adopt, amend or re-

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peal bylaws relating to the business of the corporation and the conduct of its affairs. 8 *Del. C.* § 109.

FN49. The alleged agreement in this case enables a vote by *all* shareholders. Private agreements between the board and a few large shareholders might be troubling where the agreements restrict the board's power in favor of a particular shareholder, rather than in favor of shareholders at large.

b. Paramount, QVC, and Omnicare

*7 Defendants cite three Supreme Court of Delaware cases [FN50] in support of their second argument that the agreement in this case should be unenforceable as a matter of law. [FN51] Generally speaking, these cases stand for the proposition that a contract is unenforceable if it would require the board to refrain from acting when the board's fiduciary duties require action. [FN52]

FN50. Defendants cite *Paramount Comm'ns Inc. v. QVC Network Inc.,* 637 A.2d 34, 41-42 (Del.1994); *Quickturn Design Sys., Inc. v. Shapiro,* 721 A.2d 1281, 1292 (Del.1998); and ***Omnicare, Inc. v. NCS Healthcare, Inc.,* 818 A.2d 914, 938 (Del. 2003)**.

FN51. Defs.' Reply Br. at 3.

FN52. *Id.*

Stripped of its verbiage, defendants' argument is that the News Corp. board impermissibly disabled its fiduciary duty to shareholders by putting into *shareholders'* hands the decision whether to keep a poison pill. [FN53] The three cases cited by defendants do not operate to invalidate contracts of this sort. Each of the three cases cited by defendants invalidated contracts the board used in order to take power *out* of shareholders' hands.

FN53. Although they do not explicitly say so, defendants presumably envision a scenario where the board might conclude, in the face of a hostile takeover, that it was in the best interests of shareholders to extend the Company's poison pill. If the board had previously contracted to submit the pill to a shareholder vote and if that shareholder vote were looming on the horizon, then, defendants argue, the board would be unable to adopt an effective pill-defense. Alternatively, defendants could be arguing that in a situation where the shareholder vote on the pill had already taken place, then the board would be precluded from exercising its fiduciary duty if it determined that adoption of a poison pill was in the best interests of shareholders. Both versions of defendants' argument fail insofar as they are intended to suggest that the alleged agreement is contrary to a supervening directorial fiduciary duty.

In *Paramount* the board agreed with an acquiror--Viacom--to adopt deal protective measures, including a no-shop provision, a termination fee, and a grant of stock options to the acquiror. [FN54] When a competing bidder-- QVC--offered shareholders more for their shares, the target board refused to negotiate on the grounds that they were precluded from doing so by the contractual agreements with Viacom. [FN55] The Supreme Court held that these contractual provisions were invalid and unenforceable to the extent they limited the directors' fiduciary duties under Delaware law or prevented the directors from carrying out their fiduciary duties under Delaware law. [FN56]

FN54. *Paramount,* 637 A.2d at 39.

FN55. *Id.* at 48.

FN56. *Id.*

In *Quickturn* the board amended the company's poison pill so that no newly elected board could redeem the pill for six months after taking office.

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[FN57] This "delayed redemption provision" was adopted as a defensive measure in response to a tender offer by a would-be acquiror. [FN58] The Supreme Court held that the provision was invalid and unenforceable because it would prevent a future board from rescinding the poison pill, even in circumstances where the future board concluded that redeeming the pill was in the best interests of shareholders.

> FN57. *Quickturn,* 721 A.2d at 1287 (Del.1998).

> FN58. *Id.* at 1284.

The contracts in *Paramount* and *Quickturn* were defensive measures that took power out of the hands of shareholders. [FN59] The contracts raised the "omnipresent specter" [FN60] that the board was using the contract provisions to entrench itself, *i.e.,* to prevent shareholders from entering into a value-enhancing transaction with a competing acquiror. [FN61] In this case, the challenged contract put the power to block or permit a transaction directly into the hands of shareholders. Unlike in *Paramount* and *Quickturn,* there is no risk of entrenchment in this case because shareholders will make the decision for themselves whether to adopt a defensive measure or leave the corporation susceptible to takeover.

> FN59. The board of directors in *Paramount* used the challenged contracts to make certain transactions more expensive in order to favor the board's preferred bidder. In *Quickturn,* the board of directors used the invalidated contracts to entrench itself.

> FN60. *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946, 954 (Del.1985); *see also Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc .,* 506 A.2d 173, 180 (Del.1986).

> FN61. *Omnicare,* 818 A.2d at 931.

In *Omnicare* the board entered into a merger agreement with an acquiror. [FN62] As part of the merger agreement, the board agreed to submit the merger agreement to stockholders even if the board later determined the merger was not in the best interests of shareholders. [FN63] Also as part of the merger agreement, two directors who were shareholders irrevocably committed to vote in favor of the merger. [FN64] These two directors owned a majority of the company's voting power. The result of these deal protective measures was that the deal was completely locked-up. [FN65] The Supreme Court of Delaware held that the agreement to submit the deal to a shareholder vote was unenforceable because it resulted in the board disabling its ability to exercise its fiduciary duties to the minority shareholders. [FN66]

> FN62. *Id.* at 925.

> FN63. *Id.*

> FN64. *Id.* at 926.

> FN65. *Id.* at 918.

> FN66. *Id.* at 937.

*8 *Omnicare* does not invalidate the contract in this case. Unlike the board in *Omnicare,* the News Corp. board entered into a contract that empowered shareholders; it gave shareholders a voice in a particular corporate governance matter, *viz.,* the poison pill. It makes no sense to argue that the News Corp. board somehow disabled its fiduciary duties to shareholders by agreeing to let the shareholders vote on whether to keep a poison pill in place. This argument is an attempt to use fiduciary duties in a way that misconceives the purpose of fiduciary duties. Fiduciary duties exist in order to fill the gaps in the contractual relationship between the shareholders and directors of the corporation. [FN67] Fiduciary duties cannot be used to silence shareholders and prevent them from specifying what the corporate contract is to say. [FN68] Shareholders should be permitted to fill a particular gap in the

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corporate contract if they wish to fill it. This point can be made by reference to principles of agency law: Agents frequently have to act in situations where they do not know exactly how their principal would like them to act. In such situations, the law says the agent must act in the best interests of the principal. Where the principal wishes to make known to the agent exactly which actions the principal wishes to be taken, the agent cannot refuse to listen on the grounds that this is not in the best interests of the principal.

FN67. *See* Frank H. Easterbrook & Daniel R. Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 92-93 (1998) ("... the fiduciary principle is a rule for completing incomplete bargains in a contractual structure ...").

FN68. I do not mean to suggest that the News Corp. directors have no fiduciary duties with respect to the shareholder vote. The directors have a duty to fully inform shareholders and to structure the vote so that, as much as possible, risks of improper coercion are reduced.

To the extent defendants argue that the board's fiduciary duties would be disabled after a hypothetical shareholder vote, this argument also misconceives the nature and purpose of fiduciary duties. Once the corporate contract is made explicit on a particular issue, the directors must act in accordance with the amended corporate contract. There is no more need for the gap-filling role performed by fiduciary duty analysis. [FN69] Again, the same point can be made by reference to principles of agency law: Where the principal makes known to the agent exactly which actions the principal wishes to be taken, the agent must act in accordance with those instructions.

FN69. See Easterbrook & Fischel, *supra* n. 54, at 92-93 ("Because the fiduciary principle is a rule for completing incomplete bargains in a contractual structure, it makes little sense to say that "fiduciary duties" trump *actual* contracts" (emphasis in original).

C. Count II--Promissory Estoppel

In order to assert a claim for promissory estoppel, plaintiffs must adequately allege: (1) a promise was made; (2) it was the reasonable expectation of the promisor to induce reliance or forbearance on the part of the promisee; (3) the promisee reasonably relied on the promise and took action to his detriment; and (4) injustice can be avoided only by enforcement of the promise. [FN70]

FN70. *Lord v. Souder*, 748 A.2d 393, 399 (Del.2000).

The complaint does not describe with any detail when defendants allegedly promised that the poison pill would not be rolled over without a shareholder vote. But making all inferences in plaintiffs' favor, the complaint can be read to allege that an oral promise was made during conversations that ensued between representatives of News Corp. and plaintiffs. For this reason, I conclude that plaintiffs' promissory estoppel claim survives defendants' motion to dismiss with respect to plaintiffs' allegations of an oral promise between Phillip and O'Sullivan.

D. Count III--Fraud

*9 The plaintiffs' third claim is for fraud. In order to plead common law fraud in Delaware, plaintiffs must aver facts supporting the following elements: (1) the defendant made a false representation, usually one of fact; (2) the defendant had knowledge or belief that the representation was false, or made the representation with requisite indifference to the truth; (3) the defendant had the intent to induce the plaintiff to act or refrain from acting; (4) the plaintiff acted or did not act in justifiable reliance on the representation; and (5) the plaintiff suffered damages as a result of such reliance. [FN71] Fraud claims are subject to the heightened pleading standards of Rule 9(b). [FN72]

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FN71. *Albert v. Alex. Brown Management Services, Inc.*, 2005 WL 2130607, at *7 (Del. Ch. Aug. 26, 2005).

FN72. *Id.*

The complaint does not allege who made a fraudulent representation or the contents of that misrepresentation. [FN73] That a representation was even made is not directly alleged in the complaint but is an inference that can be drawn in plaintiffs' favor if the complaint is read very broadly. Because plaintiffs fail to plead facts supporting a claim of fraud, I must grant defendants' motion as to this claim.

FN73. *C.V. One v. Resources Group*, Del.Super., 1982 WL 172863, at *3 (Dec. 14, 1982) (dismissing fraud claim where "the person who made the misrepresentation is not named.")

E. Count IV--Negligent Misrepresentation and Equitable Fraud

To successfully assert a claim for negligent misrepresentation, plaintiff must adequately plead: (1) the defendant had a pecuniary duty to provide accurate information; (2) the defendant supplied false information; (3) the defendant failed to exercise reasonable care in obtaining or communicating the information; and (4) the plaintiff suffered a pecuniary loss caused by justifiable reliance upon the false information. [FN74] Plaintiffs have failed to assert with any specificity what false documents or false statements they relied upon in connection with the alleged injury or who produced them. [FN75] Plaintiffs' complaint suffers from a second problem: It fails to allege a pecuniary loss. In fact, plaintiffs state in their complaint that they "have no adequate remedy at law." [FN76] Because the complaint fails to allege who made the misrepresentation or the existence of a pecuniary loss, I must dismiss plaintiffs' claim of negligent misrepresentation.

FN74. *Steinman v. Levine*, 2002 WL 31761252 (Del. Ch. Nov. 27, 2002) (citing *Sanders v. Devine*, 1997 WL 599539, at *6-7 (Del. Ch. Sept. 24, 1997) and *Wolf v. Magness Constr. Co.*, 1995 WL 571896, at *2 (Del. Ch. Sept. 11, 1995), *aff'd*, 676 A.2d 905 (Del.1996)).

FN75. *See Steinman v. Levine*, 2002 WL 31761252, at *15 (Del. Ch. Aug. 6, 2002) (Dismissing negligent misrepresentation claim against multiple defendants where complaint failed to identify misrepresentations made by any particular director defendant.)

FN76. Compl. ¶ 104.

Plaintiffs have also failed to adequately plead equitable fraud. Equitable fraud is subject to Rule 9(b)'s heightened pleading standard. [FN77] The complaint contains no more facts supporting a claim of equitable fraud than it does facts supporting a fraud claim. I grant defendants' motion to dismiss with respect to Count IV.

FN77. *Shamrock Holdings of California, Inc. v. Iger*, 2005 WL 1377490, at *7 (Del. Ch. June 06, 2005).

F. Count V--Breach of Fiduciary Duty

Count V of the complaint alleges the directors breached their fiduciary duties. The complaint is bereft of any facts that suggest a violation of the duty of loyalty. Plaintiffs do not allege that the decision to extend the pill without a shareholder vote was in any way self-interested. [FN78] The complaint also fails to allege any facts that support a claim for breach of the duty of care. Plaintiffs do not allege that the director defendants were uninformed about their decision to extend the poison pill without a shareholder vote or that they did so in bad faith.

FN78. Pls.' Answering Br. at 47 (acknowledging that "[p]laintiffs do not challenge the *bona fides* of the Pill.")

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*10 Plaintiffs do not allege facts supporting a violation of either the duty of loyalty or the duty of care. As a result of these pleading deficiencies, I dismiss Count V of the complaint.

III. CONCLUSION

The complaint adequately states claims for breach of contract (count I) and promissory estoppel (count II). The burden is now on the plaintiffs to prove that a contract or promise was actually made that the Board Policy would be irrevocable. The motion to dismiss is granted with regard to plaintiffs' claims for fraud (count III), equitable fraud and negligent misrepresentation (count IV), and breach of fiduciary duty (count V).

IT IS SO ORDERED.

Not Reported in A.2d, 2005 WL 3529317 (Del.Ch.), 31 Del. J. Corp. L. 1186

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