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Would the CSX/Conrail Express Have Derailed in Delaware? A Comparative Analysis of Lock-Up Provisions Under Delaware and Pennsylvania Law

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Would the CSX/Conrail Express Have Derailed in Delaware? A Comparative Analysis of Lock-Up Provisions Under Delaware and Pennsylvania Law

VINCENT F. GARRITY, JR. AND MARK A. MORTON*

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I. INTRODUCTION

On October 15, 1996, CSX Corporation ("CSX"), owner of the third largest railroad in the United States, announced that it had agreed to acquire Conrail Inc. ("Conrail"), owner of the nation's fifth largest

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The authors drafted and submitted this Article during the pendency of the bidding war by CSX and Norfolk for Conrail. As a result, the Article only addresses factual and legal developments through early January of 1997. The authors have attached an epilogue in order to address events occurring after that time in the battle for control of Conrail.

railroad, for cash and securities valued at slightly over \$8 billion.¹ Within days, rival Norfolk Southern Corporation ("Norfolk"), owner of the remaining major railroad in the eastern United States, weighed in with an all cash hostile bid of approximately \$9.1 billion for Conrail.² However, while Norfolk's original bid and each of its subsequent bids have offered a greater value than the cash and stock proposals of CSX, so far Norfolk's efforts to acquire Conrail have been stymied by, *inter alia*, certain defensive provisions in the Agreement and Plan of Merger by and among Conrail, Green Acquisition Corp., a wholly-owned subsidiary of CSX ("Green"), and CSX dated as of October 14, 1996 (the "Merger Agreement").³ Indeed, Conrail has utilized these defensive provisions, commonly known as "lock-ups,"⁴ as its principal defense in its efforts to fend off Norfolk's hostile advances and the United States District Court for the Eastern District of Pennsylvania so far has deferred to the Conrail board's business judgment in agreeing to include "lock-up" provisions in the Merger Agreement and accordingly the court has declined to invalidate the "lock-ups" under Pennsylvania law.

However, the deference paid by the district court to the Conrail board's decision to adopt and maintain in place various "lock-up" provisions has prompted some to consider whether the Delaware courts would have reached the same conclusion concerning the adoption and use of the "lock-up" provisions if litigation had been filed in the Delaware Court of Chancery and Conrail had been a Delaware, rather than a Pennsylvania, corporation. In the discussion that follows, the authors examine this question and conclude that it is likely that the Delaware courts, unlike the district court, would have invalidated some or all of the "lock-up" provisions employed by Conrail and CSX.⁵

1. Steven Lipin & Daniel Machalaba, *CSX Agrees to Acquire Conrail for \$8.1 Billion in Cash and Stock*, WALL ST. J., Oct. 16, 1996, at A3.

2. Steven Lipin et al., *Norfolk Southern Bids \$9.1 Billion for Conrail*, WALL ST. J., Oct. 24, 1996, at A3.

3. The parties to the Merger Agreement agreed to amend the Agreement on November 5, 1996 (the "First Amendment") and December 18, 1996 (the "Second Amendment").

4. Although some commentators define the term "lock-up" narrowly, *see, e.g.*, DENNIS J. BLOCK, ET AL., *THE BUSINESS JUDGMENT RULE 404* (4th ed. 1995), the Delaware courts treat the term more expansively and, as a general matter, have considered stock options, termination fees, and no-shop provisions to be types of "lock-up" devices. *See, e.g.*, *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 176 (Del. 1986); *Yanow v. Scientific Leasing, Inc.*, C.A. Nos. 9536 & 9561, 1988 WL 8772, at *5 (Del. Ch. Feb. 8, 1988). For purposes of this Article, the authors have employed a similarly expansive definition of "lock-ups" and have treated each of the devices employed in the Merger Agreement as a "lock-up" device.

5. For purposes of this Article, the authors have not attempted to survey Pennsylvania court decisions concerning lock-ups. Rather, the authors have examined only the district court's decisions which have been rendered in connection with the proposed Conrail/CSX merger. The authors have, however, surveyed each decision of the Delaware courts that has addressed similar lock-up provisions under Delaware law.

II. THE PROPOSED CONRAIL/CSX MERGER

On October 15, 1996, Conrail and CSX announced that Conrail had agreed to be acquired by CSX through a multi-tiered structure which included a front-end loaded cash tender offer (in two stages) followed by a back-end merger (the "CSX Proposal").⁶ Pursuant to the Merger Agreement, CSX agreed to make an initial cash tender offer for up to 19.9% of Conrail stock at a price of \$92.50 per share (the "First CSX Offer").⁷ Thereafter, Conrail would call and hold a special stockholders' meeting at which the stockholders would vote on a proposed amendment to the Articles of Incorporation of Conrail (the "Charter Amendment")⁸ whereby Conrail would opt out of, i.e., render inapplicable, Subchapter 25E of the Pennsylvania Business Corporation Law (the "PBCL").⁹ Provided the Conrail stockholders shall have approved the Charter Amendment, CSX further agreed to follow its first step cash tender offer with a second step cash tender for up to 20.1% of Conrail's shares at \$92.50 per share.¹⁰ Finally, Conrail has agreed to call another special stockholders' meeting at which the Conrail stockholders would be asked to approve a merger of Conrail with and into Green, the wholly-owned acquisition subsidiary of CSX, pursuant to which the holder of each Conrail share would receive either a combination of CSX stock and cash (if the Charter Amendment was approved) or a number of shares of CSX stock based upon the price of CSX stock on the date the merger was announced.¹¹

Significantly, the Merger Agreement incorporated a number of

6. See Press Release from Conrail (Oct. 15, 1996) (hereinafter Oct. 15 Conrail Press Release); see also Offer to Purchase for Cash an Aggregate of 17,860,124 Shares of Common Stock and Series A ESOP Convertible Junior Preferred Stock of Conrail Inc. by Green Acquisition Corp. (Oct. 16, 1996) (hereinafter Oct. 16 Green Offer); Fourth Amended Complaint ¶ 15, *Norfolk Southern Corp.* (C.A. No. 96-CV-7167) (hereinafter Complaint).

7. See Oct. 15 Conrail Press Release, *supra* note 6; Oct. 16 Green Offer, *supra* note 6. Based upon Conrail's closing price of \$71.00 per share on the day before the announcement of the proposed merger, Conrail's shareholders stood to receive a significant premium for their shares.

8. See Oct. 15 Conrail Press Release, *supra* note 6; Oct. 16 Green Offer, *supra* note 6.

9. Section 25E requires any person acquiring control of 20% or more of a Pennsylvania "registered" corporation, as defined therein, to acquire, upon demand, all other shares of the corporation for a "fair price" in cash. 15 PA. CONS. STAT. ANN. §2541-2548 (West 1996). Because the scope of this Article is limited to an examination of the lock-ups agreed to by Conrail's board, the authors have not attempted to address the ramifications or general applicability of Chapter 25 of the PBCL or its other takeover provisions.

10. See Oct. 15 Conrail Press Release, *supra* note 6; Oct. 16 Green Offer, *supra* note 6.

11. See Agreement and Plan of Merger art. II (Oct. 14, 1996) (hereinafter Merger Agreement). The Merger Agreement also provided that the board of directors of the surviving corporation would be divided equally between directors selected by Conrail and directors selected by CSX and that the corporate headquarters of the surviving entity would be located in Philadelphia, with Mr. LeVan as the immediate President and COO, his selection as CEO in two years and his selection as Chairman in four years.

"lock-up" provisions. First, Section 5.9(b) of the Merger provided for the payment of a "break-up" or termination fee¹² of \$300 million, which represented at the time more than 3% of the transaction price. Second, concurrent with the Merger Agreement, Conrail and CSX entered into an option agreement pursuant to which Conrail granted CSX a stock option¹³ to acquire for \$92.50 in cash per share approximately 10% of Conrail's shares. Notably, in this case, there was no "cap" or upper limit in place on the economic benefit that CSX would realize from exercising this option. Third, Section 4.2 of the Merger Agreement included a form of no-shop, which provided, subject to certain exceptions, that Conrail's directors may not (i) solicit, or participate in negotiations concerning, another proposal,¹⁴ (ii) approve or recommend another proposal, or (iii) withdraw or modify their recommendation of the CSX Proposal for a period of 180 days (i.e., until April 15, 1997).¹⁵ Finally, in addition to agreeing to amend its poison pill¹⁶ to exempt the CSX Proposal, Conrail agreed, pursuant to Sections 3.1 and 5.14 of the Merger Agreement, that it would not (i) further amend its poison pill without the prior consent of CSX, or (ii) take any action with respect to its poison pill plan to facilitate any offer (other than the CSX Proposal) to acquire Conrail.¹⁷

A. *The Norfolk Offer*

In response to the CSX Proposal, Norfolk announced on October

12. A "break-up" or termination fee requires a target corporation to pay a fixed sum to the proposed merger partner in the event that the merger transaction is not consummated. *See* BLOCK, *supra* note 4, at 440-41. Courts in a number of jurisdictions have upheld reasonable break-up fees. *See id.* at 441.

13. In merger transactions, the target corporation frequently grants a friendly acquiror an option to purchase a block of the target's stock, which the acquiror usually may exercise only after it acquires a predetermined ownership position in the target. *See id.* at 404. In circumstances where the stock option provides the acquiror with a foothold, but not the right to seize control, the courts typically have upheld the options. *See id.*

14. Conrail was entitled to provide information to and to negotiate with an unsolicited competing bidder only until the earliest of (i) the completion of the First CSX Offer, (ii) the approval of the CSX Proposal by the Conrail stockholders, or (iii) December 31, 1998. *See* Merger Agreement, *supra* note 11, § 4.2.

15. No shop provisions "are promises by a corporation to deal exclusively with the white knight, and not to solicit or provide information to a third party, and, in the absence of a fiduciary out, not to accept a later, better offer." BLOCK, *supra* note 4, at 426-27.

16. Typically, the "poison pill," or shareholders rights plan adopted by a board of directors, provides for the issuance of an uncertificated right to each stockholder of the company. *See id.* at 520-21. In the event of certain triggering events, including the accumulation of a certain amount of the company's stock by a third party without the board's consent, the holder of such uncertificated right becomes entitled to purchase one or more shares of the company's common stock at a substantially discounted price, resulting in a lethal economic detriment to the third party who is not eligible to receive the rights. *See id.* at 521-22.

17. *See* Complaint, *supra* note 6, ¶ 5.

23, 1996 its intention to commence, through a wholly-owned subsidiary, a cash tender offer for any and all shares of Conrail stock for \$100 per share (the "Norfolk Offer") or \$9.1 billion, which offer would be followed by a cash merger at the same price (collectively, the "Norfolk Proposal").¹⁸ In addition, since the Norfolk Offer also provides that a voting trust will be created to hold the Conrail stock acquired by Norfolk either pursuant to its offer or subsequent merger, the Conrail stockholders would receive immediate payment for their shares in connection with each step of the Norfolk Proposal, unlike the CSX Proposal in which payment of the "back-end" consideration would be deferred until regulatory approval of the merger was obtained.¹⁹ Finally, in a letter delivered to the board of directors of Conrail on the same date, Norfolk expressed its interest in negotiating a friendly merger with Conrail and stated that all aspects of the Norfolk Proposal remained flexible.²⁰ In particular, the letter noted that Norfolk would consider adding a substantial equity component to its proposal, if so desired, so that the Conrail stockholders would retain a continuing equity interest in the surviving company.²¹

The Norfolk Proposal was conditioned upon, among other things, (i) Norfolk having obtained sufficient financing for the Norfolk Proposal, (ii) the valid tender of a majority of the shares of Conrail's stock, (iii) the inapplicability of Subchapter 25F (a "Business Combination" anti-takeover provision) of the PBCL to the Norfolk Offer, (iv) receipt of an informal written opinion of the Surface Transportation Board ("STB") confirming that the use of a voting trust is consistent with the policies of the STB, (v) the termination of the Merger Agreement, and (vi) Conrail's poison pill either having been redeemed or amended so as to exempt the Norfolk Proposal.²²

B. CSX Responds to the Norfolk Offer

On November 6, 1996, Conrail and CSX announced that they had amended the original Merger Agreement in several key respects (the "First Amendment").²³ First, CSX agreed to increase the cash portion

18. See *id.* ¶ 15. Based upon the closing \$71.00 market price of Conrail's stock on the day before the CSX Proposal, the Norfolk Proposal represented a 40% premium. See *id.*

19. See *Norfolk Southern Plans All Cash \$100 per Share Offer for Conrail*, Bus. Wire, Oct. 23, 1996, available in LEXIS, News Library, Wires File.

20. See Complaint, *supra* note 6, ¶ 16.

21. See *id.*

22. See Offer to Purchase for Cash Shares of Common Stock and Series A ESOP Convertible Junior Preferred Stock of Conrail, Inc. by Atlantic Acquisition Corporation, a Wholly-Owned Subsidiary of Norfolk Southern Corporation (Oct. 24, 1996); see also *Norfolk Southern Plans All Cash \$100 per Share Offer for Conrail*, *supra* note 19.

23. See Supplement dated Nov. 6, 1996, to the Offer to Purchase of CSX Corporation dated Oct. 16, 1996.

(at both stages) of its proposed transaction to \$110 per share of Conrail stock (the "Second CSX Offer").²⁴ The Second CSX Offer did not, however, change the back-end consideration originally offered by CSX.²⁵ Second, the First Amendment included an amendment to Section 4.2(a) of the Merger Agreement to extend to nine months the period of time during which the Conrail Board cannot withdraw its support of the Merger Agreement or agree to any competing transactions.²⁶ As a result of the adoption of the First Amendment on November 5, 1996, the "lock-out" provisions imposed by section 4.2(a) (the "Lock-Out") on the Conrail Board were to run through July 12, 1997.²⁷ Third, the First Amendment also provided for a new section 4.3, which had been requested by Conrail, that prohibited both Conrail and CSX from engaging in discussions or entering into any agreement with any railroad company, including Norfolk, relating to trackage rights or other concessions without the consent of the other party.²⁸ Finally, CSX announced that the expiration date for the CSX Proposal would be extended from midnight on November 15 to midnight on November 20, 1996.²⁹ Due to the First Amendment, Conrail also announced the cancellation of the November 14th special meeting of stockholders of Conrail and that the rescheduled meeting was likely to be held in mid-December.³⁰ On November 7th, one day after the announcement of the Second CSX Offer, Norfolk responded and increased its offer for all shares of Conrail's stock to \$110 per share.³¹

C. *The First Preliminary Injunction Hearing*

On November 18 and 19, 1996, the district court held a hearing on Norfolk's motion for a preliminary injunction to enjoin CSX from closing its first stage cash tender offer for up to 19.9% of the shares of Conrail's stock. At the hearing, Norfolk contended, *inter alia*, that the Conrail directors had breached their fiduciary duties when they agreed to the CSX Proposal and that the Conrail stockholders were being illegally

24. *See id.*

25. *See id.* According to Norfolk, the value of the back-end consideration, based upon the closing sales price of CSX stock on November 7, 1996, was only \$82.14 per share of Conrail stock and therefore the blended value of the improved CSX Proposal was approximately \$93 per share. *See* Complaint, *supra* note 6, ¶ 50.

26. *See* Complaint, *supra* note 6, ¶ 50.

27. *See id.*

28. *See id.*

29. *See id.*

30. *See id.* Subsequently, Conrail announced that the special meeting of its stockholders, which originally was to be held on November 14, 1996, would be rescheduled for December 23, 1996. *See id.* ¶ 51; Complaint, *supra* note 6, ¶ 51.

31. *See* Supplement dated Nov. 8, 1996 to the Offer to Purchase of Norfolk Southern Corporation dated Oct. 24, 1996.

coerced by the terms of the CSX Proposal to tender their shares to CSX.³² In an oral ruling delivered at the conclusion of the hearing on November 19, 1996, the district court denied the motion for a preliminary injunction after concluding that (i) the members of the Conrail board of directors had not violated their fiduciary duties, and (ii) the CSX Proposal was not coercive.³³

Before addressing Norfolk's allegation that the Conrail board members had breached their fiduciary duties, the district court first sought to determine what the board's fiduciary duties entailed and to whom those duties were owed. According to the court, section 1712 of the PBCL sets forth the general duties of directors and imposes a fiduciary obligation on each director to perform his or her duties in good faith and in a manner such director reasonably believes to be in the best interests of the corporation.³⁴ This duty, the court noted, "is to the corporation; not necessarily to the shareholders."³⁵

The fiduciary duties of the board of directors are "further spelled out," according to the court, by section 1715 of the PBCL, which "expressly and perhaps uniquely provides that directors may consider all groups that may be affected by their actions, including shareholders, employees, customers, [and the] communities in which the corporate offices and facilities are located and [they] may consider both the short-term and the long-term interests of the corporation."³⁶ In fact, the court

32. See Transcript of Hearing 640 (Nov. 18-19, 1996) (hereinafter November Bench Ruling).

33. See *id.* at 646, 652.

34. See 15 PA. CONS. STAT. ANN. § 1712(a) (West 1996). Section 1712(a) provides, in pertinent part, that:

a director of a business corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director . . . in good faith, in a manner he reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances.

35. November Bench Ruling, *supra* note 32, at 642.

36. *Id.* at 642 (citing section 1715(a) of the PBCL). Section 1715(a) provides that:

(a). GENERAL RULE. In discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a business corporation may, in considering the best interests of a corporation, consider to the extent they deem appropriate:

(1) The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.

(2) The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.

(3) The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation.

notes, when the board is considering the best interests of the corporation, or the effects of its actions, the board is not required to "consider the interests of any group, obviously including shareholders, as a dominant or controlling factor" in its decision making process.³⁷

Moreover, the court added, subsection 1715(c): further qualifies directors' obligations by expressly providing that the directors's fiduciary

duties shall not be deemed to require the [directors] . . . [to] redeem any rights under or to modify or render inapplicable any shareholders' rights plans [or to] . . . render inapplicable or make determinations under subchapter E relating to control transactions . . . [or] [s]ubchapter F relating to business combinations . . . [or] to act solely because of the effect such action might have on an acquisition or potential acquisition of control, or the consideration that might be offered or paid to shareholders in such an acquisition.³⁸

Finally, the Court noted that, pursuant to Section 1715(d) of the PBCL, "any act relating to an acquisition to which a majority of the

(4) All other pertinent factors.

The court added that section 1716 of the PBCL "reiterates" the statement in section 1715(a) that directors may consider the effects of its decisions on stockholders, employees, suppliers, customers and the communities in which the company operates when making a decision. *Id.* at 645-46.

37. *Id.* at 643 (citing section 1715(b) of the PBCL). Section 1715(b) provides that the board "shall not be required, in considering the best interests of the corporation or the effect of any action, to regard any corporate interest or the interests of any particular group affected by such action as a dominant or controlling interest or factor" and the board's "consideration of interests and factors in the manner described in this subsection and in [1715(a)] shall not constitute a violation" of the standard of care set forth in section 1712 of the PBCL. Once again, in the court's view, section 1716 reiterates the statement in section 1715(b) that "no factor [considered by the board] need be predominant." *Id.* at 646.

38. *Id.* at 643-44 (citing section 1715 (c) of the PBCL). Section 1715(c) provides that:

(c) Specific applications. - In exercising the powers vested in the corporation, including, without limitation, those powers pursuant to section 1502 (relating to general powers), and in no way limiting the discretion of the board of directors, committees of the board and individual directors pursuant to subsections (a) and (b), the fiduciary duty of directors shall not be deemed to require them:

(1) to redeem any rights under, or to modify or render inapplicable, any shareholder rights plans, including, but not limited to, a plan adopted pursuant or made subject to section 2513 (relating to disparate treatment of certain persons);

(2) to render inapplicable, or make determinations under, the provisions of Subchapter E (relating to control transactions), Subchapter F (relating to business combinations), Subchapter G (relating to control-share acquisitions) or Subchapter H (relating to disgorgement by certain controlling shareholders following attempts to acquire control) of Subchapter 25 or under any other provision of this title relating to or affecting acquisitions or potential or proposed acquisitions of control; or

(3) to act as the board of directors, a committee of the board or an individual director solely because of the effect such action might have on an acquisition or potential or proposed acquisition of control of the corporation or the consideration that might be offered or paid to shareholders in such an acquisition.

disinterested directors shall have assented shall be presumed" to have satisfied the directors' fiduciary duties under section 1712 unless "it is proven by clear and convincing evidence that the disinterested directors did not assent to such act in good faith after reasonable investigation."³⁹

In this case, the court concluded the board's actions had been approved by a majority of the disinterested directors.⁴⁰ Therefore, under section 1715(d) of the PBCL, the plaintiffs had an obligation to prove, by clear and convincing evidence, that the board did not render its decisions in good faith after reasonable investigation.⁴¹ Since the plaintiffs failed to meet this burden, the court held that "[f]or this reason alone, the grant of preliminary injunction may not be granted."⁴²

In addition to reaching its holding, however, the court offered the following commentary on the plaintiffs' arguments, the policy underlying the applicable provisions of the PBCL and the wisdom of certain examples of Delaware jurisprudence:

Basically it seems to me that the plaintiffs are contending that the sole or at least the primary consideration by a board of directors in considering a competing offer . . . should be which competitor offers the best short-range price or profit for shareholders. Clearly Pennsylvania statutory law is expressly against such a contention. . . .

It seems clear that the Pennsylvania statutes to which I have referred were enacted with the decisions of the Delaware State Courts and particularly [*Unocal*] *Corporation v. Mesa Petroleum Corporation*, and *Revlon, Incorporated v. MacAndrews and Forbes Holdings, Incorporated* . . . in mind and in order to exclude those . . . decisions that seem to mandate or suggest that the primary or perhaps only consideration in a situation where there is an attempted takeover . . . is what is the best financial deal for the stockholders in the short term.

Although those decisions may be fine for the shareholders whose only interest is that of a short-term financial investment to maximize their profits, it completely ignores the economic utility and value of corporations as a form of business enterprise that produces goods and services for the public and in the national economy, in this case railroad services.

Directors have the right to consider these matters, and by statute

39. *Id.* at 644-45 (citing section 1715(d) of the PBCL). Section 1715(d) provides, in pertinent part, that:

Absent breach of fiduciary duty, lack of good faith or self-dealing, any act as the board of directors, a committee of the board or an individual director shall be presumed to be in the best interest of the corporation.

40. *See id.* at 646.

41. *See id.*

42. *Id.*

in Pennsylvania they have the right to consider all matter including not only the rights of shareholders and financial interests of shareholders, but these other so-called constituencies.⁴³

Finally, the court criticized both the "myopic view" of the Delaware courts in the *Unocal* and *Revlon* line of cases that the interests of stockholders should be given the highest priority, as well as the practical problem of placing business decisions in the hands of judges rather than in the hands of sophisticated business managers.⁴⁴

The court also rejected plaintiffs' claim that the CSX Proposal was unlawfully and unfairly coercing the Conrail stockholders to tender. To the contrary, the court held, "I do not see any coercion, but only several options, any of which will undoubtedly end up being a net return to most shareholders far in excess of whatever their original investment may have been."⁴⁵

In conclusion, the court held

that it is clear from the Pennsylvania statutes . . . that it is up to the board of directors and they alone . . . [to determine] what is in the best interests of the corporation. And that the directors have every right to favor one competing bid over another and particularly have the right to resist hostile takeovers by such methods as poison pills, shareholders' rights, making recommendations to shareholders, favoring one proposed corporate party over the other, and using stock options in favor of one corporation over another, and include extensive so-called break-up fees. And certainly it seems to me that it can agree not to shop their proposal after signing a merger agreement.⁴⁶

D. CSX Closes First Step Tender Offer and Commences Second Step Tender Offer/Conrail Schedules Stockholder Vote on Charter Amendment

When the Second CSX Offer expired at midnight on November 20, 1996, CSX closed on its purchase of 19.9% of the Conrail stock.⁴⁷ Several days later, on November 25, 1996, CSX announced that a special meeting of stockholders would be held on December 23, 1996 (the "December Special Meeting"), for purposes of conducting a vote of

43. See *id.* at 646-48.

44. See *id.* at 649.

45. *Id.* at 652. As the court observed, the stockholders' options included, *inter alia*, (i) the right to tender their shares and then vote against the merger, (ii) the right to tender their shares and then vote for the merger, (iii) the right to hold their shares, and (iv) the right to sell their shares into the market prior to the consummation of the CSX Proposal. See *id.* at 650-52.

46. *Id.* at 655.

47. See Complaint, *supra* note 6, ¶ 66. Since approximately 85% of the shares of Conrail stock were tendered to CSX, the company was required to accept shares on a pro rata basis. See *id.*

Conrail's stockholders on the Charter Amendment⁴⁸ and, on December 6, CSX commenced its second step tender offer to purchase up to an aggregate of 18,344,845 (or approximately 20%) of additional shares of Conrail's stock at \$110 per share (the "Second Step Offer").⁴⁹ The CSX Second Step Offer was conditioned, *inter alia*, on approval of the Charter Amendment by the Conrail stockholders.⁵⁰

E. *The Second Preliminary Injunction Hearing*

In response to Conrail's statement that it did not intend to convene the December Special Meeting unless the company had sufficient proxies to win approval of the Charter Amendment,⁵¹ Norfolk asked the court to grant a preliminary injunction prohibiting Conrail from postponing the December Special Meeting.⁵² On December 17, 1996, the court held a hearing to consider plaintiffs' motion for preliminary injunction. Characterizing the manner in which the vote was to be held as "fundamentally unfair" and as amounting to a "sham election," the court granted the plaintiffs' motion and enjoined Conrail from postponing, adjourning or not convening the December Special Meeting, absent intervening material events.⁵³

F. *CSX Increases Offer By Adding Convertible Preferred Stock*

On December 19th, only two days after the court granted plaintiffs' motion for a preliminary injunction, Conrail and CSX announced that

48. *See id.* at ¶ 69. Notably, however, the terms of the Merger Agreement prohibited Conrail from convening the December Special Meeting without CSX's consent. *See id.* at ¶ 70. CSX's ability to control whether the December Special Meeting was to be held prompted substantial criticism from the media. For example, one local newspaper chose to characterize the December Special Meeting as follows:

As elections go, this one might have been devised in the old Kremlin: Conrail shareholders are scheduled to vote December 23 on a proposal that will likely decide the Philadelphia railroad's future. If they approve the management endorsed proposal, Conrail's planned \$8.5 billion merger with CSX Corp. will move forward. If the shareholders don't approve . . . they won't vote.

In other words, count ballots first, then hold the vote - after we've won.
Id. ¶ 71 (quoting *The Philadelphia Inquirer*, November 28, 1996).

49. *See id.* ¶ 75.

50. *See id.*

51. Following the First Amendment to the Merger Agreement, Conrail no longer unilaterally controlled whether or not the December Special Meeting would be convened, adjourned or postponed. As revised by the First Amendment to the Merger Agreement, Section 5.1(b) of the Merger Agreement now provides, *inter alia*, that Conrail "shall not convene, adjourn or postpone the [Conrail] Pennsylvania Shareholders Meeting without the prior consent of [CSX], which consent shall not be unreasonably withheld."

52. *See id.* ¶ 19.

53. Transcript of Hearing 71-72 (Dec. 17, 1996) (hereinafter December Bench Ruling); *see also* Complaint, *supra* note 6, ¶ 77.

they had adopted the Second Amendment to the Merger Agreement. Pursuant to the Second Amendment, the Conrail stockholders would receive, in addition to the cash and stock previously offered, convertible preferred stock to be valued at \$16 per share.⁵⁴ Finally, Conrail and CSX announced that the Second Amendment to the Merger Agreement had extended the expiration date for the Lock-Out provision to December 31, 1998.⁵⁵ Conrail also announced that, due to these changes, the special meeting of stockholders to consider and vote upon the Charter Amendment, previously scheduled to be held on December 23, 1997, instead would be held on January 17, 1997 (the "January Special Meeting").⁵⁶

G. *Norfolk Raises Its Cash Offer to \$115 Per Share*

Within hours of CSX's announcement, Norfolk announced that it had increased its cash offer to \$115 per share (the "Revised Norfolk Offer").⁵⁷ Pursuant to the Revised Norfolk Offer, the Conrail stockholders would receive a premium of more than \$12 per share over the blended value of CSX's revised cash and stock proposal for Conrail (or an aggregate premium of approximately \$1 billion over the CSX Proposal).⁵⁸

H. *The Third Preliminary Injunction Hearing*

In a hearing before the district court on January 9, 1997, Norfolk argued that Conrail's adoption of a two year lock-out constituted an abdication by the board of its fiduciary duties. Therefore, Norfolk maintained, the court should declare the lock-out to be *ultra vires*.⁵⁹ However, the court remained untroubled by the length of the lock-out, holding that:

54. See Complaint, *supra* note 6, ¶ 79. According to *The Wall Street Journal*, the Third CSX Offer, including the Convertible Preferred Stock, was worth \$102 per share. See Steven Lipin & Ana Wilde Mathews, *Norfolk Sweetens Hostile Bid for Conrail Hours After CSX Raises Friendly Offer*, WALL ST. J., Dec. 20, 1996, at A3.

55. See Complaint, *supra* note 6, ¶ 79.

56. See *id.* ¶ 20.

57. See Second Supplement to the Offer to Purchase for Cash Dated October 24, 1996 (Dec. 20, 1996); see also Complaint, *supra* note 6, ¶¶ 20, 82.

58. See Complaint, *supra* note 6, ¶ 22.

59. Transcript of Hearing 68-69 (Jan. 9, 1997) (hereinafter January Bench Ruling). As noted earlier, the scope of this article is limited to an examination of the lock-ups agreed to by the Conrail Board. Consequently, although the plaintiffs raised other, unrelated, contentions at this hearing, including an allegation that CSX and the Conrail directors and senior management, alleged to be acting in concert, had triggered the fair value provisions of PBCL Chapter 25E because the shares of Conrail owned by its directors and senior management be aggregated with the 19.9% of Conrail's stock purchased by CSX, this Article does not examine the issues raised by such discussion.

As to the 720-day period no-shop or lockout period . . .

I see no principled reason . . . as to why the lockout could not extend for the full period of the contract, nor is there any reason to think that any particular line of demarcation need be drawn so far as the facts of this case presently before me are concerned. After all, as it seems to me, and I think I expressed this previously, that where a contract is entered into, it is expected that the parties will act in good faith and will not deliberately go out and attempt to shop the contract, if you will, with some other party or to see if they can get a better deal after having entered into a valid contract.⁶⁰

In addition, the court concluded that the Conrail board had not erred when it agreed to a lock-out without a fiduciary out.⁶¹ According to the court, even if the Conrail board were to develop a fiduciary duty in the future to "go ahead and take some action by reason of some offer that had been made," the court saw no "reason why [it] should make any difference that [the fiduciary out] is not specifically set forth in the contract."⁶² In the court's view:

if a contract imposes upon certain of the parties certain fiduciary duties, it seems to me that [the fiduciary duties] then become[] practically an unwritten term of the contract of the agreement. And therefore whether this one did not have such a fiduciary duty opt-out and the earlier one did seems to me should make no difference. In addition to which there has been absolutely no showing or [] claim that any situation has arisen as yet or will or is likely to arise in the future that would impose any sort of fiduciary duty upon the board of directors to disregard the lockout or the no-shop provisions of the merger agreement.⁶³

For these reasons, the court denied plaintiffs' request for a preliminary injunction against enforcement of the lock-out provision.⁶⁴

III. DELAWARE LAW

When negotiating an acquisition that will be governed by Delaware law, the board of directors of an acquirer frequently attempts to protect the negotiated deal (and ensure its completion) by including "lock-up" provisions in the acquisition agreement. The board of directors of the Delaware target, on the other hand, usually will agree to include such lock-up provisions if the board determines that the provisions will assist the board in negotiating the highest and best offer for the company. It is

60. *Id.* at 149-50.

61. *See id.* at 150-51.

62. *Id.* at 150.

63. *Id.*

64. *See id.* at 161.

the tension between these two competing and frequently opposing uses for lock-up devices and the circumstances under which these lock-ups are being adopted which must be carefully considered by the directors of a Delaware target when they agree to include such defensive provisions in the agreement acquisition.

In transactions governed by Delaware law, the board of Delaware target typically will be asked by the acquiror to include one or more of the following types of lock-up provisions in the acquisition agreement:

- a. a stock option, pursuant to which a holder receives an irrevocable option to purchase a substantial portion of the company's stock;⁶⁵
- b. a termination or "break-up" fee, in a negotiated amount designed to compensate the bidder if another bidder prevails and which is similar to a liquidated damages provision;⁶⁶
- c. "no shop" or "window shop" provisions, which limit the board's ability to solicit or communicate with other potential bidders;⁶⁷
- d. a "topping" fee, to be paid to the original bidder if the company accepts another bidder's offer and which is based upon a negotiated percentage of the amount by which the subsequent offeror's bid exceeds the original bid;⁶⁸
- e. an expense reimbursement provision, which is designed to compensate a bidder for its actual or estimated out-of-pocket expenses in the event that another bidder ultimately prevails;⁶⁹
- f. an asset option, pursuant to which the bidder receives an irrevocable option to purchase at a negotiated price a particularly desirable asset or division of the company.⁷⁰

As a general matter, such lock-ups are not considered to be *per se*

65. See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994); *In re Vitalink Communications Corp. Shareholders Litig.*, C.A. No. 12085, 1991 WL 238816, at *3, (Del. Ch. Nov. 8, 1991); *Yanow v. Scientific Leasing, Inc.*, C.A. Nos. 9536 & 9561, 1988 WL 8772, at *5 (Del. Ch. Feb. 8, 1988).

66. See *Roberts v. General Instrument Corp.*, C.A. No. 11639, 1990 WL 118356, at *2 (Del. Ch. Aug. 13, 1990); *In re Formica Corp. Shareholders Litig.*, C.A. No. 10598, 1989 WL 25812, at *7 (Del. Ch. Mar. 22, 1989); *In re J.P. Stevens & Co.*, 542 A.2d 770 (Del. Ch. 1988).

67. See *QVC*, 637 A.2d 34; *In re Vitalink*, 1991 WL 238816, at *15-16; *Lewis v. Leaseway Transp. Corp.*, C.A. No. 8720, 1990 WL 67383, at *3 (Del. Ch. May 16, 1990).

68. See *In re KDI Corp. Shareholders Litig.*, C.A. No. 10278, 1990 WL 201385 (Del. Ch. Dec. 13, 1990).

69. See *Kahn v. Dairy Mart Convenience Stores, Inc.*, C.A. No. 12489, 1996 WL 159628, at *3 (Del. Ch. Mar. 29, 1996).

70. See *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1988); *In re Holly Farms Corp. Shareholders Litig.*, C.A. No. 10350, 1988 WL 143010, at *2 (Del. Ch. Dec. 30, 1988).

illegal under Delaware law.⁷¹ To the contrary, in the majority of the decisions considering the validity of particular lock-up provisions, the Delaware courts have upheld their reasonable use and have recognized their potential benefits to the stockholders of Delaware corporations. For example, the Delaware courts have approved the use of termination fees, topping fees and expense reimbursement provisions where the fees or expenses are capped at a percentage of the value of the proposed transaction (typically 1-2%).⁷² The Delaware courts also have recognized that it may be appropriate for a board to grant a bidder an option to purchase as much as 20% of the company's capital stock.⁷³ Finally, provided that the target company is afforded the opportunity to respond to legitimate unsolicited offers, the Delaware courts generally have given approval to the use of no-shop and window shop provisions.⁷⁴

However, before a Delaware court will consider the propriety of a challenged lock-up provision in an acquisition agreement, the court must resolve the threshold issue of determining the appropriate standard of review under which the lock-up will be considered.

A. *Standards of Review*

An analysis of the appropriate standard of review to be applied by the Delaware courts first requires a discussion of the business judgment rule. Under Delaware corporate law, the business and affairs of a Delaware corporation are to be managed by or under the direction of its board of directors. In recognition of the managerial prerogatives granted to directors of Delaware corporations, Delaware law presumes that, in making a business decision, the directors of a corporation were disinterested and acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation.⁷⁵

Under an application of the business judgment rule, the judgment of the board of directors will be respected by the Delaware courts if, upon review, the court concludes the directors' decision can be attrib-

71. See *Macmillan*, 559 A.2d at 1284.

72. See, e.g., *In re Formica Corp. Shareholders Litig.*, C.A. No. 10598, 1989 WL 25812 (Del. Ch. Mar. 22, 1989); *In re J.P. Stevens & Co.*, 542 A.2d 770, 781-83 (Del. Ch. 1988); *Lewis*, 1990 WL 67383; *Roberts v. General Instrument Corp.*, C.A. No. 11639, 1990 WL 118356 (Del. Ch. Aug. 13, 1990). But see *QVC*, 637 A.2d at 49-51.

73. See, e.g., *In re Vitalink Communications Corp. Shareholders Litig.*, C.A. No. 12085, 1991 WL 238816, at *3 (Del. Ch. Nov. 8, 1991); *Hecco Ventures v. Sea-Land Corp.*, C.A. No. 8486, 1986 WL 5840 (Del. Ch. May 19, 1986); *Yanow v. Scientific Leasing, Inc.*, C.A. Nos. 9536 & 9561, 1991 WL 165304 (Del. Ch. Feb. 8, 1988). But see *QVC*, 637 A.2d at 49-51.

74. See, e.g., *In re KDI Corp. Shareholders Litig.*, C.A. No. 10278, 1990 WL 201385 (Del. Ch. Dec. 13, 1990) *In re Vitalink*, 1991 WL 238816.

75. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); see also DEL. CODE ANN. tit. 8 § 141.

uted to any rational business purpose.⁷⁶ If there is a challenge to the decision of the board and the business judgment rule is applicable, the burden is on the party challenging the decision to establish facts rebutting the presumption of the business judgment rule.⁷⁷ As with any decision of the board of directors, as a general rule the use of lock-ups is a function of a board's business judgment and, therefore, absent certain circumstances of the type discussed below, if there is any rational business purpose for the use of lock-up provisions, a Delaware court will not interfere with the board's decision to grant such lock-up provisions. Where, however, the board agrees to lock-ups in response to a hostile threat to the control of the company, the board's decision to adopt such provisions will implicate the enhanced judicial scrutiny mandated by *Unocal Corp. v. Mesa Petroleum, Inc.*⁷⁸

Under *Unocal*, before a board may be entitled to the protections afforded by the business judgment rule, the board of directors must demonstrate that it had reasonable grounds to believe that a threat to corporate policy and effectiveness existed and that the defensive measures adopted were reasonable in relation to the threat posed.⁷⁹ The first prong of *Unocal* is satisfied by a showing that a reasonable investigation into the threat was undertaken in good faith. The second prong of *Unocal* focuses on whether the challenged measures were either preclusive or coercive and, if not, whether the measures fell within a "range of reasonableness."⁸⁰

If the plaintiff successfully rebuts the presumption of the business judgment rule in challenging a lock-up device or if the majority of the board is found to be interested in the transaction which contains the lock-up provisions, the Delaware courts will examine the board of directors' actions under the entire fairness standard set forth in *Weinberger*.⁸¹ In an entire fairness test context, directors of a Delaware corporation must demonstrate

their utmost good faith and the most scrupulous inherent fairness of the bargain The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.⁸²

76. See *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1374 (Del. 1995).

77. See *Aronson v. Lewis*, 473 A.2d at 812.

78. 493 A.2d 946 (Del. 1985).

79. See *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1152 (Del. 1989); *Unocal*, 493 A.2d at 946.

80. *Unitrin, Inc.*, 651 A.2d at 1387-88; *QVC*, 637 A.2d at 45-46.

81. See *Weinberger v. VOP, Inc.*, 457 A.2d 701, 711 (Del. 1983); see also *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995); *Unitrin, Inc.*, 651 A.2d at 1377, n.18.

82. *Weinberger*, 457 A.2d at 710.

Under the entire fairness standard, the board of directors must establish "to the court's satisfaction that the transaction was the product of both fair dealing and fair price."⁸³ In analyzing whether there has been fair dealing, the Delaware courts consider questions of when the transaction was timed, how it was initiated, structured, negotiated and disclosed to the directors and how the approvals of the directors and the stockholders were obtained.⁸⁴ In considering the issue of fair price, the court analyzes the economic and financial considerations of the proposed transaction, including all relevant factors.⁸⁵

While the test is typically denominated in two parts, the test is not bifurcated between fair dealing and fair price. Under the relevant law, "all aspects of the issue must be examined as a whole since the question is one of entire fairness."⁸⁶ In making its determination, the Delaware Chancery Court must "carefully analyze the factual circumstances, apply a disciplined balancing test to its findings, and articulate the bases upon which it decides the ultimate question of entire fairness."⁸⁷

Finally, a Delaware court would consider whether the Conrail board had a duty under *Revlon* to act reasonably to seek the transaction offering the best value reasonably available to the stockholders, and the board must exercise its fiduciary duties to further that goal.⁸⁸ In the context of any sale or change or control, the Delaware courts will apply enhanced scrutiny to ensure that the directors have acted reasonably.⁸⁹ The key features of an enhanced scrutiny test are (i) a judicial determination regarding the adequacy of the decision making process employed by the directors, including the information on which the directors based their decision,⁹⁰ and (ii) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing.⁹¹ In these circumstances, the directors will have "the burden of proving that they were adequately informed and acted reasonably."⁹²

While the Delaware courts recognize that there is "no single blueprint" that a board must follow in connection with a sale, the Dela-

83. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 856 (Del. 1994).

84. *See Weinberger*, 457 A.2d at 711.

85. *See id.*

86. *Id.*

87. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1179 (Del. 1995).

88. *See Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 44 (Del. 1994); *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986).

89. *See QVC*, 637 A.2d at 43; *Roberts v. General Instrument Corp.*, C.A. No. 11639, 1990 WL 118356, at *8 (Del. Ch. Aug. 13, 1990).

90. *See QVC*, 637 A.2d at 45.

91. *See id.*; *Roberts*, 1990 WL 118356, at *8.

92. *QVC*, 637 A.2d at 45.

ware decisions suggest that a board may determine the existence and viability of possible alternatives through a number of methods, including, but not limited to, an auction, a canvassing of the market, or the gathering of enough reliable evidence to enable the board to render an informed decision.⁹³ The overriding principle guiding the board's judgment when selling a company must be the scrupulous adherence to ordinary principles of fairness in whatever form the sale takes, whether in the form of an active auction, a buyout or a restructuring.⁹⁴

Before Delaware law will impose such special obligations on the board of directors, the corporation must undertake a transaction that will cause either a sale or change of control of the corporate entity.⁹⁵ However, where two public companies are widely held and neither company has a controlling stockholder or stockholder group, a stock for stock merger between the two companies will not constitute a change of control.⁹⁶ Absent a change of control, the board may, consistent with its fiduciary duties, prefer a preexisting transaction without becoming subject to *Revlon* duties⁹⁷ and the board of directors has "the prerogative . . . to resist a third party's unsolicited acquisition proposal or offer."⁹⁸

B. Delaware Cases Analyzing Lock-ups under the *Unocal* Standard

In *In re Santa Fe Pacific Corp. Shareholder Lit.*, the Delaware Supreme Court reversed the chancery court's decision dismissing plaintiffs' *Unocal* claim relating to the reasonableness of a termination fee and expense reimbursement provision in a merger agreement between Santa Fe and Burlington Northern. In originally dismissing plaintiffs' duty of loyalty claim, the chancery court first noted that the complaint failed to allege that the board did not reasonably perceive a threat to corporate policy and effectiveness.⁹⁹ Second, the chancery court rejected plaintiffs' assertion that the \$50 million termination fee was "coercive" under the second prong of *Unocal* and held that the defensive measures adopted by the Board (including the termination fee) were a "reasonable, proportionate response to the threat posed."¹⁰⁰ The chan-

93. See *QVC*, 637 A.2d at 44; *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1287 (Del. 1989).

94. See *Mills Acquisition Corp. v. Macmillan, Inc.*, 559 A.2d 1261, 1285 (Del. 1988).

95. See *In re Santa Fe Pacific Corp. Shareholder Litig.*, 669 A.2d 59, 71 (Del. 1995); *QVC*, 637 A.2d at 48.

96. See *In re Santa Fe*, 669 A.2d at 71.

97. See *Time*, 571 A.2d at 1151; *In re Santa Fe Pacific Corp. Shareholder Litig.*, C.A. No. 13587, 1995 WL 334258, at *8 (Del. Ch. May 31, 1995), *aff'd in part, rev'd in part*, 669 A.2d 59 (Del. 1995).

98. *QVC*, 637 A.2d at 43 n.13.

99. *In re Santa Fe*, 1995 WL 334258, at *9.

100. *In re Santa Fe*, 1995 WL 334258, at *11.

cery court, relying on *QVC*, noted in a footnote that

[u]nder Delaware law, the Santa Fe board was free to agree to reasonable termination fees and expenses. . . . Given the magnitude of the transaction in question (over \$3.5 billion), nothing alleged in the complaint gives rise to a claim that the \$50 million termination fee and the \$10 million dollar expense reimbursement provision were not reasonable.¹⁰¹

The Delaware Supreme Court held, however, that the chancery court erred in dismissing plaintiff's *Unocal* claim because the court had relied on evidence outside of the complaint to reach its conclusion. According to the court, enhanced judicial scrutiny generally will not be satisfied by resting on a defense motion merely attacking the pleadings. Thus, the supreme court reversed the dismissal of the *Unocal* claim on technical grounds and never reached the merits of the court of chancery's decision.¹⁰²

C. Delaware Cases Analyzing Lock-ups under the Entire Fairness Standard

Under Delaware law, directors are required to demonstrate both their utmost good faith and the most scrupulous inherent fairness of a transaction in which they possess a financial, business or other personal interest which does not devolve upon the corporation or all stockholders generally.¹⁰³ When directors of Delaware corporations are faced with such divided loyalties, the directors have the burden of establishing the entire fairness of the transaction such that it will survive careful scrutiny by the courts.¹⁰⁴

In *Cinerama*, Technicolor's board agreed to a two-tiered tender offer proposal by MacAndrews & Forbes. Several months after the tender offer was completed, Technicolor completed the merger pursuant to the previously agreed upon merger agreement. In the subsequent lawsuit brought by Cinerama, a shareholder of Technicolor, Cinerama argued that the merger was not the product of fair dealing. Specifically, Cinerama alleged that the transaction was unfairly structured because it

101. *In re Santa Fe*, 1995 WL 334258, at *10 n.8.

102. *See In re Santa Fe Pacific Corp. Shareholder Litig.*, 669 A.2d 59, 72 (Del. 1995); *see also Wells Fargo & Co. v. First Interstate Bancorp.*, C.A. Nos. 14696 & 14623, 1996 WL 32169, at *6 (Del. Ch. Jan. 18, 1996). In refusing to dismiss the *Unocal* claim relating to certain lock-ups, the chancery court noted that it was "tempted to agree" with defendants' argument that the break-up fees and stock option, which together represented a cost of approximately 2% of the transaction value, were not coercive or preclusive or outside a range of reasonableness, but left that final decision for fuller development in the litigation in light of the supreme court's decision in *Santa Fe*.

103. *See Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

104. *See Mills Acquisition Corp. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1988).

"unquestionably 'inhibited . . . alternative bids.'" In addition, the plaintiff further alleged that the transaction was "locked up, included a no-shop provision, and gave Technicolor no 'out,' i.e., no right to terminate."¹⁰⁵ In rejecting this entire fairness argument, the Delaware Supreme Court observed that

Cinerama's assertion that the merger agreement included a 'no-shop' clause that 'inhibit[ed] [the] board's ability to negotiate with other potential bidders' is not supported by the record. Although it is true that Technicolor could not shop for competing bids, it successfully preserved its right to provide information to, and engage in discussions with, competing bidders.¹⁰⁶

D. Delaware Cases Analyzing Lock-ups under the Revlon Standard

Not surprisingly, the majority of the cases in Delaware that consider the propriety of lock-ups are those in which the board agreed to lock-ups in connection with a sale of the company. It is under these circumstances that shareholder plaintiffs and potential bidders perceive the most harm from the use of lock-ups, most specifically as "show stoppers" or possible deterrents to further bidding. If the board of directors of a Delaware corporation determines to engage in a transaction in which control of the corporation will change, the directors are required to critically evaluate whether all material aspects of the proposed transaction, including any lock-ups, both separately and in the aggregate, are reasonable and in the best interests of the stockholders.¹⁰⁷ Typically, a board of directors' *Revlon* duties have been analyzed in one of three contexts: a sale of the company involving a single bidder where the board has reliable evidence as to the fairness of the transaction, a sale of the company involving a single bidder where the board relies upon a subsequent market check to verify the fairness of the transaction, or a sale of the company involving multiple bidders.

Where directors are considering a single offer and they possess a "body of reliable evidence with which to evaluate the fairness of a transaction, they may approve that transaction without conducting an active survey of the market."¹⁰⁸ In *Barkan*, for example, the Delaware Supreme Court affirmed the chancery court's finding that the board, despite agreeing during negotiations to the imposition of a no-shop pro-

105. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1173 (Del. 1995).

106. *Cinerama*, 663 A.2d at 1173.

107. See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 48 (Del. 1994).

108. *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1287 (Del. 1989); see also *In re Vitalink Communications Corp. Shareholders Litig.*, C.A. No. 12085, 1991 WL 238816, at *11 (Del. Ch. Nov. 8, 1991).

vision, had sufficient knowledge of the relevant markets to form a basis for its belief that it had acted in the best interests of the stockholders when it subsequently approved management's buy out of the company.¹⁰⁹ In *In re Vitalink*, the chancery court, in reaching its conclusion that the Vitalink board had a sufficient basis of reliable evidence to enable it to reasonably conclude that it was getting the best deal possible for the stockholders, agreed with Vitalink's arguments that the lock-up option, the no-shop clause and the termination fee were minimal impediments to an implicit market test.¹¹⁰

Where directors are considering a single offer and they do not have reliable grounds upon which to judge the adequacy of the offer, "a concern for fairness demands a canvas of the market to determine if higher bids may be elicited."¹¹¹ In *In re Vitalink*, the chancery court concluded that the actions of the Vitalink board did not constitute a canvass of the market. Nonetheless, the court held that the no-shop clause, which was subject to a fiduciary out clause, the stock option, which was for 19.9% of the company's common stock, and the termination fee of \$2,771,331, which represented slightly less than 1.9% of the value of the transaction, did not prevent the company from canvassing the market.¹¹² In *In re KDI Corp. Shareholders Litigation*, a special committee of the board of directors of KDI entered into a merger agreement with management pursuant to which the company and the special committee agreed not to solicit any other offer for the company. In granting defendants' motion to dismiss the complaint, the Vice Chancellor noted that the company was "in play" for nearly three months before the merger agreement was executed and, during that time, the company's investment banker contacted nearly 100 potential purchasers. In the court's view, these facts plus the fact that the agreement with the no-shop provision was not executed "until the process of selling KDI was at a close. . . ." negate[d] any inference that the Special Committee acted without due care.¹¹³

Where multiple bidders are attempting to bid for control of a com-

109. See *Barkan*, 567 A.2d at 1288.

110. See *In re Vitalink*, 1991 WL 238816, at *12.

111. *Barkan*, 567 A.2d at 1287; see also *In re Vitalink*, 1991 WL 238816, at *6; *In re Fort Howard Corp. Shareholders Litig.*, C.A. No. 9991, 1988 WL 83147, at *13 (Del. Ch. Aug. 8, 1988), *appeal denied*, 547 A.2d 633 (Del. 1988).

112. See *In re Vitalink*, 1991 WL 238816, at *7.

113. *In re KDI Shareholders*, 1990 WL 201385, at *4; compare *Rand v. Western Airlines, Inc.*, C.A. No. 8632, 1989 WL 104933, at *4 (Del. Ch. Sept. 11, 1989) (refusing to dismiss complaint's *Revlon* claim where there were no other bidders for company and complaint alleged that 30% stock option had been granted to only bidder, that no fairness opinion was obtained on price of the stock option, that merger agreement contained a no-shop clause, and that merger price was slightly less than company's recent trading price and approximately half of its alleged asset and synergy value).

pany, a concern for fairness forbids directors from using defensive mechanisms to thwart an auction or to favor one bidder over another.¹¹⁴ While the Delaware courts have held that lock-up and no-shop provisions are not *per se* illegal, the courts recognize that such measures "often foreclose further bidding to the detriment of shareholders, and end active auctions prematurely."¹¹⁵ For an auction-ending provision to be appropriate, the provision "must confer a substantial benefit upon the stockholders in order to withstand exacting scrutiny by the courts."¹¹⁶ Before the board agrees to include various lock-ups in an acquisition agreement, the board must consider whether the lock-ups in question would adversely affect the value provided to the stockholders, inhibit or encourage alternative bids, remain enforceable contractual obligations in light of the directors' fiduciary obligations, and ultimately advance or retard the directors' obligation to secure for the stockholders the best value reasonably available under the circumstances.¹¹⁷

In *Revlon*, during an active auction for the sale of control of the company, the Revlon board accepted a revised offer from Forstmann Little which contained a lock-up option to purchase certain of Revlon's important assets at below market prices, a no-shop provision and a \$25 million termination fee. MacAndrews and Forbes Holdings, Inc., the other bidder for Revlon, sought to enjoin the asset lock-up, the no-shop and the termination fee provisions of the merger agreement. The Delaware Supreme Court upheld the chancery court's invalidation of these lock-up provisions. The court held that, once the board permitted management to negotiate a merger or a buy-out, there was a recognition that the company was for sale. In such circumstances, the duty of the board changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit.¹¹⁸ The court then went on to consider the lock-ups, noting that, while those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders' detriment. The court noted that while the no-shop provision was not illegal *per se*, its use is "impermissible" when the board has determined to sell the company and the board is responsible for selling the company to the highest bidder.¹¹⁹ Similarly, with respect to the asset option, the court determined that the

114. See *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182-85 (Del. 1986).

115. *Mills Acquisition Corp. v. Macmillan*, 559 A.2d 1261, 1284 (Del. 1988).

116. *Id.*; see also *Rand*, 1989 WL 104933, at *.

117. See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 48 (Del. 1994).

118. See *Revlon*, 506 A.2d at 182.

119. *Id.* at 184.

option was not used to foster the bidding. Rather, the court held that the option was used to "destroy" the bidding process, especially where the asset option was granted for little additional consideration and at below market prices.¹²⁰ Finally, the supreme court affirmed the ruling of the chancery court enjoining the termination fee, finding that such fee was part of the overall plan to thwart the bidding process.¹²¹

In *Macmillan*, in the midst of a heated auction for the sale of the company, and in the face of an offer by Maxwell to top any other offer, the board of directors of Macmillan accepted a bid from and entered into a merger agreement with KKR. The merger agreement included an asset lock-up for the purchase of seven Macmillan subsidiaries for \$865 million, a no-shop provision, an expense reimbursement provision and a breakup fee of \$29.3 million. Maxwell, the other bidder for Macmillan, sought to enjoin the asset lock-up agreement and the breakup fees and expenses granted by the Macmillan board to KKR. Although the chancery court denied the requested injunction, the supreme court reversed.

In reviewing the asset lock-up and no-shop provisions, the court noted that while such agreements are not *per se* illegal, nevertheless they "often foreclose further bidding to the detriment of shareholders, and end active actions prematurely."¹²² According to the supreme court, "if the grant of such an auction ending provision is appropriate, it must confer a substantial benefit upon the stockholders in order to withstand exacting scrutiny by the Courts."¹²³ When, however, the decision of the directors granting such lock-ups was not informed or was induced by breaches of fiduciary duties, such lock-ups cannot survive.¹²⁴

As for the asset lock-up option given to KKR, the court determined that the option was not necessary to draw any bidders into the contest and that Macmillan did not receive, in exchange for the lock-up, a bid which materially enhanced stockholder interests. According to the court, "when one compares what KKR received for the lock-up, in contrast to its inconsiderable offer, the invalidity of the agreement becomes patent."¹²⁵ Of particular note, the supreme court was concerned with an asset lock-up involving the company's "crown jewels," those particularly valuable or desirable assets or lines of business of the target company. While the court indicated that a lock-up of such assets may be permissible, the granting by the board of that lock-up must involve careful scrutiny. Where such a lock-up is granted to end an active auction,

120. *See id.*

121. *See id.*

122. *Mills Acquisition Corp. v. MacMillan, Inc.*, 559 A.2d 1261, 1284 (Del. 1988).

123. *Id.*

124. *See id.*

125. *Id.* at 1286.

the board must attempt to negotiate alternative bids before granting such a significant concession.¹²⁶ With respect to the no-shop clause granted to KKR, the court noted that the use of such a device is even more limited than a lock-up agreement. According to the court, "[a]bsent a material advantage to the stockholders from the terms or structure of a bid that is contingent on a no-shop clause, a successful bidder imposing such a condition must be prepared to survive the careful scrutiny which that concession demands."¹²⁷ Finally, while the supreme Court did not directly address the propriety of the break-up fee and the reimbursement of expenses provisions of the KKR merger agreement, the court did completely reverse the chancery court's decision, including that portion of the decision which refused to enjoin those provisions.¹²⁸ Thus, it can be assumed that the court found those provisions, granted under the circumstances of this case, to be objectionable as well.

In *QVC*, the Delaware Supreme Court affirmed the court of chancery's preliminary injunction preventing the implementation of no-shop and stock option provisions in a merger agreement between Paramount and Viacom. In addressing *QVC*'s challenge to these lock-ups, the supreme court concluded that Paramount had put itself up for sale and, in that context, the Paramount board did not pay sufficient attention to "the potential consequences of the defensive measures demanded by Viacom." These consequences included (i) upon certain triggering events, the option either to purchase, with a senior subordinated note of questionable value, approximately 19.9% of Paramount's outstanding common stock at \$69.14 per share or to require Paramount to pay Viacom in cash a sum equal to the immediate cash value of such option, and (ii) a no-shop provision that "inhibited the Paramount Board's ability to negotiate with other potential bidders, particularly *QVC* which had already expressed an interest in Paramount."¹²⁹ Under these circumstances, the supreme court concluded, "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."¹³⁰ For that reason, the court found the stock option agreement and the no-shop clause were improperly designed to deter potential bidders and, consequently, were invalid and unenforceable.¹³¹

The supreme court's decision in *QVC* is also important for what it

126. *See id.* at 1286.

127. *Id.*

128. *See id.* at 1288.

129. *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 49 (Del. 1994).

130. *Id.* at 50.

131. *See id.* at 51.

did not decide. First, while the chancery court determined preliminarily that a \$100 million termination fee, which represented only 1.2% of the value of the original transaction fee, was reasonable, the issue was not appealed by either party to the supreme court.¹³² Therefore, the supreme court could only note that the termination fee "whether or not unreasonable by itself, clearly made Paramount less attractive to other bidders, when coupled with the [stock option]."¹³³ While this *dicta* suggests that the Delaware courts will consider the aggregate effect of all of the lock-ups, we are left without binding precedent to that effect. Second, the court declined to express an opinion as to "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."¹³⁴ Thus, it remains unclear under Delaware law at what point a stock option becomes too large or too costly. Finally, in discussing the lock-ups in question, the court observed that such contractual provisions "may not validly define or limit the directors' fiduciary duties under Delaware law or prevent . . . directors from carrying out their fiduciary duties under Delaware law" and, therefore, Viacom did not have any vested contract rights arising from such provisions.¹³⁵

In *In re Holly Farms Corp. Shareholders Litigation*, the board of Holly Farms was faced with two competing bidders for the company: ConAgra and Tyson. In the face of Tyson's tender offer, Holly Farms, after investigating alternatives to the Tyson offer, determined that a sale of the company was in the best interests of the stockholders of Holly Farms, and the board thereupon accepted an offer from ConAgra which included an option to purchase Holly Farms' prime poultry operation, a termination fee of \$15 million and an agreement to reimburse ConAgra's expenses.¹³⁶ The chancery court granted Tyson's request for a preliminary mandatory injunction to enjoin the effectuation of these lock-ups. Although the Holly Farms board determined to sell the corporation and, therefore, should have assumed the role of auctioneer, the court found that the record "conclusively shows, however, that an auction aimed at maximizing shareholder value never really took place."¹³⁷ According to the court, while a lock-up may be rational if it encourages a bidder to make an offer, a lock-up that ends an active auction and

132. See *QVC Network, Inc. v. Paramount Communications Inc.*, 635 A.2d 1245, 1271 (Del. Ch. 1993).

133. *QVC*, 637 A.2d at 49.

134. *QVC*, 637 A.2d at 49 n.19.

135. *QVC*, 637 A.2d at 48, 50.

136. See *In re Holly Farms Corp. Shareholders Litig.*, C.A. No. 10350, 1988 WL 143010, at *2-3 (Del. Ch. Dec. 30, 1988).

137. *Id.* at *4.

precludes further bidding is "extremely suspect."¹³⁸ Under such circumstances, the court concluded, the board's decision to grant a lock-up, the termination fee and the expense reimbursement were improper because they each appeared to have been part of an effort to "preclude a genuine auction."¹³⁹

In *Hecco Ventures v. Sea-Land Corp.*, plaintiffs claimed that Sea-Land's directors violated their duty to obtain the highest possible bid for the stockholders' stock when the directors granted a 21.7% stock option to CSX.¹⁴⁰ Noting that the stock option "was granted at the conclusion (and not, as in *Revlon*, in the midst) of the auction process," and therefore the lock-up did not "shut out a bidder that was prepared to offer a higher price" for the shares, the chancery court denied plaintiffs' application for a temporary restraining order.¹⁴¹

Similarly, in *In re J.P. Stevens & Co., Inc.*, plaintiffs alleged that the topping fee and reimbursement of expenses provision both impeded an effective auction and, therefore, the board, by agreeing to such provisions, violated its *Revlon* duties.¹⁴² Rejecting plaintiffs' claim, Chancellor Allen held that the topping fee arrangement, while having the effect of giving one bidder an advantage, still may benefit the company's stockholders if it is responsible for producing another bid. In such a case, the court concluded, the topping fee is not "inconsistent with the board's duty to seek the best available transaction for the shareholders."¹⁴³ The court also concluded that similar considerations governed the analysis of the \$17 million termination fee (1% of the transaction value).¹⁴⁴ Such fees are "reasonably conventional" and where,

as appears to be the case here, such a provision is negotiated in good faith by the board with no apparent conflict, that is well-advised and follows a responsible, deliberate procedure, [the court] is at a loss as to know what basis exists for declaring such a provision a violation of a shareholders' rights.¹⁴⁵

Finally, in *Yanow v. Scientific Leasing, Inc.*, plaintiffs sought to enjoin an all-cash tender offer arguing that the stock option, expense reimbursement provision, window shop clause and management incen-

138. *Id.* at *6; see also *Thompson v. Enstar Corp.*, 509 A.2d 578, 583 (Del. Ch. 1984).

139. *In re Holly Farms*, 1988 WL 143010, at *6.

140. See *Hecco Ventures v. Sea-Land Corp.*, C.A. No. 8486, 1986 WL 5840, at *4 (Del. Ch. May 19, 1986).

141. *Id.* at *4; see also *In re Sea-Land Corp. Shareholders Litig.*, 642 A.2d 792, 806 n.19 (Del. Ch.), *aff'd*, 633 A.2d 371 (Del. 1993) (holding that grant of Sea-Land option was reasonably calculated to induce higher, firm bid from CSX and, therefore, was not fiduciary duty violation).

142. See *In re J.P. Stevens & Co.*, 542 A.2d 770, 778-81 (Del. Ch. 1988).

143. *Id.* at 782.

144. See *id.* at 783.

145. *Id.*

tive and compensation arrangements agreed to by the directors of the company effectively locked up the company and chilled further competitive bids.¹⁴⁶ In rejecting plaintiffs' claims, the chancery court noted that there had been no showing that these "arrangements constituted the type of provisions condemned as 'lock-up' devices that improperly preclude competing bids in an active auction."¹⁴⁷ Reviewing the reasonableness of each lock-up, the court held that (i) the expense reimbursement provision and the grant of an option to acquire 16% of the company's common stock only imposed a modest additional cost on any other bidder, but they were necessary in order to induce an offer from the original bidder at a premium over market, (ii) the window shop clause permitted the company to cooperate with a *bona fide* higher bidder and was consistent with the board's fiduciary duties, and (iii) there was no showing that the directors acted improperly in agreeing to the management incentive and compensation arrangements, which were negotiated after the deal price was established.¹⁴⁸

IV. AN APPLICATION OF DELAWARE LAW TO THE CONRAIL/CSX MERGER

A. *Analyzing the Conrail/CSX Lock-ups Under the Unocal Standard*

In reviewing the Conrail board's decision to agree to lock-up provisions in connection with its proposed merger with CSX, a Delaware court first would have to determine whether the lock-up provisions were defensive measures adopted in response to a threat posed by a potential hostile bidder¹⁴⁹ or were they bargained for by CSX and agreed to by Conrail as merely another component of the proposed merger. If the latter is the case, then the Conrail board's decision would have been entitled to the protections of the business judgment rule. If the former is the case, then Conrail would have been required to demonstrate that it had reasonable grounds to believe that a threat to corporate policy and effectiveness existed and that the lock-up provisions were reasonable in relation to the threat which Conrail presumably anticipated would be posed by Norfolk or any other bidder(s).¹⁵⁰ If the Conrail board would have been able to demonstrate that it had such "reasonable grounds" and that the defensive measures taken were within "a range of reasonableness," then the Conrail board's decision to adopt the lock-ups would be

146. See *Yanow v. Scientific Leasing, Inc.*, C.A. Nos. 9536 & 9561, 1988 WL 8772, at *4 (Del. Ch. Feb. 8, 1988).

147. *Id.* at 5.

148. See *id.* at *7 n.6.

149. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

150. See *id.*

entitled to the protections afforded by the business judgment rule. If the business judgment rule applied, a Delaware court would defer to the Conrail board's decision if there was any rational business purpose for agreeing to the lock-up provisions.¹⁵¹

In determining whether the lock-up provisions were "defensive measures," it is helpful to consider the lock-ups agreed to prior to the announcement of the Norfolk Offer on October 23, 1996, separate from amendments to those lock-ups (or any new lock-ups) adopted or agreed to by the Conrail board after that announcement. At first blush, it would appear that the lock-up provisions that were agreed to in connection with the proposed Conrail/CSX merger should be entitled to the protections of the business judgment rule because the Conrail/CSX merger was announced on October 15, 1996,¹⁵² more than one week before the Norfolk offer. However, certain allegations made by Norfolk in its complaint suggest that Conrail may have intended, nonetheless, that the lock-up provisions to serve as defensive measures.

According to Norfolk, in the two years preceding the announcement of the Conrail/CSX merger, members of senior management of Norfolk, including David R. Goode, Chairman and Chief Executive Officer of Norfolk, had spoken on a number of occasions with senior management of Conrail, including then Conrail Chairman and Chief Executive Officer, James A. Hagen, and current Conrail Chairman and Chief Executive Officer, David W. LeVan, concerning a possible business combination between Norfolk and Conrail.¹⁵³ According to Norfolk, as recently as late September of 1994, Norfolk and Conrail had been negotiating a proposed stock for stock merger of Conrail and Norfolk.¹⁵⁴ In light of the foregoing, a Delaware court may well conclude that the lock-ups were, in fact, defensive mechanisms and therefore subject the Conrail board's decision to adopt those lock-ups to enhanced judicial scrutiny under *Unocal*.

Whether the lock-up provisions (including the lock-out) were intended to be defensive measures or not, the decision of the Conrail board to amend the Merger Agreement less than two weeks after the Norfolk Proposal in order, *inter alia*, to extend the lock-out provision to nine months (and later to more than two years) does appear to have been defensive in nature and, consequently, a Delaware court should subject at least the board's decision to extend the lock-out to the enhanced judi-

151. See *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1374 (Del. 1995).

152. See Oct. 15 Conrail Press Release, *supra* note 6.

153. See Complaint, *supra* note 6, ¶ 23.

154. See *id.* ¶ 26.

cial scrutiny articulated in *Unocal*.¹⁵⁵

Under *Unocal*, the Conrail directors would have the burden of establishing that they had reasonable grounds to believe that a threat to corporate policy and effectiveness existed and that the defensive measures adopted were reasonable in relation to the threat posed.¹⁵⁶ The first prong of the *Unocal* test is satisfied by showing that a reasonable investigation was undertaken by the board in good faith.¹⁵⁷ The second prong of *Unocal* turns on whether the defensive measures are preclusive or coercive and, if not, whether the measures fall within a "range of reasonableness."¹⁵⁸ Here, the pleadings may not be fairly characterized as having demonstrated, and the decisions of the district court did not address, whether a "reasonable investigation" of a perceived threat was undertaken in good faith. However, even if such an investigation was undertaken by the Conrail board, under the second prong of *Unocal*, the authors believe that several of the lock-out provisions are nevertheless arguably outside the range of reasonableness.

Although typically the Delaware courts have approved of termination fees and expense reimbursement provisions that are in the range of 1-2% of the value of the proposed transaction,¹⁵⁹ in this case the termination fee of \$300 million¹⁶⁰ represented nearly 3.75% of the value of the initial offer of CSX (valued at slightly over \$8.0 billion).¹⁶¹ Similarly, while the stock option in this case is for a modest percentage of the shares of Conrail,¹⁶² the stock option is not capped to limit its maximum dollar value. Thus, as the price of Conrail stock appreciated during the course of the bidding war between CSX and Norfolk, the cash value of the stock option also increased. In *QVC*, the Delaware Supreme Court was critical of another stock option that was not capped and referred to the option as both "unusual" and "draconian" in its application. The

155. See *In re Santa Fe Pacific Corp. Shareholder Litig.*, C.A. No. 13587 1995 WL 334258 at *9 n.7 (Del. Ch. May 31, 1995). In footnote 7 of that opinion, the chancery court observed that "once the board determined to alter the [transaction] in response to the unwanted [bid], the altered transaction . . . became subject to enhanced scrutiny under *Unocal*." *Id.*

156. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1152 (Del. 1989).

157. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

158. *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995).

159. See, e.g., *In re Formica Corp. Shareholders Litig.*, C.A. No. 10598, 1989 WL 25812 (Del. Ch. Mar. 22, 1989); *In re J.P. Stevens & Co., Inc.*, 542 A.2d 770, 781-83 (Del. Ch. 1988); *Lewis v. Leaseway Trans. Corp.*, C.A. No. 8720, 1990 WL 67383 (Del. Ch. May 16, 1990); *Roberts v. General Instrument Corp.*, C.A. No. 11639, 1990 WL 118356 (Del. Ch. Aug. 13, 1990).

160. See *Merger Agreement*, *supra* note 11, § 5.9(b).

161. See *Lipin & Machalaba*, *supra* note 1, at A3.

162. On several occasions the Delaware courts have declined to invalidate options considerably larger than CSX's 10% option. See, e.g., *In re Vitalink Communications Corp. Shareholders Litig.*, C.A. No. 12985, 1991 WL 238816, at *6, 12 (Del. Ch. Nov. 8, 1991); *Hecco Ventures v. Sea-Land Corp.*, C.A. No. 8486, 1986 WL 5840, AT *4-5 (Del. Ch. May 19, 1986); *Yanow v. Scientific Leasing, Inc.*, C.A. Nos. 9536 & 9561, 1988 WL 8772 at *4-6 (Del. Ch. Feb. 8, 1988).

authors also believe that a Delaware court would be troubled by the board's agreement not to amend the company's poison pill without the consent of a third party. Such an agreement eliminates Conrail's otherwise unilateral right to amend the poison pill in order to effect an alternative transaction with another bidder, irrespective of the price offered or the conditions of the deal and is at least facially incompatible with the rationale for a deal. The authors are not aware of any Delaware decision that has condoned such a result. To the contrary, the Delaware courts have indicated that circumstances may arise where a board will no longer be justified in maintaining a poison pill in order to prevent the shareholders from accepting the offer.¹⁶³ Since the Conrail board's agreement not to amend the poison pill without the consent of CSX leaves the board without the ability to respond to such circumstances, it is the view of the authors that such an agreement would be viewed by the Delaware courts as an abdication by the board of its fiduciary duties.

Finally, if a Delaware court examined the lock-out provision under the enhanced judicial scrutiny called for by *Unocal*, the authors believe that a Delaware court would conclude that the Conrail board's response was preclusive in its effect.¹⁶⁴ By definition, a lock-out provision, which prevents a target company from approving or recommending any other transaction (irrespective of its merits) or from withdrawing from a proposed merger (irrespective of subsequent events) for an unreasonably lengthy period of time is preclusive. In this case, the Conrail board went even further, however, because it twice responded to offers from Norfolk by revising the lock-out provision in order to extend its duration (first to 270 days and ultimately to a length of approximately 850 days). The authors are unaware of any decision that has endorsed a lock-up period of the type, scope or magnitude of even the *original* 180 day lock-out provision, let alone the ultimate lock-out provision of over two years. Indeed, under Delaware law, such a provision would appear to be an impermissible delegation (or in Norfolk's view, an abdication) of the board's fiduciary duty. As a result, the authors believe that a Delaware court would conclude that the lock-out is unreasonable, preclusive and, therefore, unenforceable.

163. See *City Capital Assoc., L.P. v. Interco, Inc.*, 551 A.2d 787, 798 (Del. Ch. 1988) (where facts suggested that shareholders might prefer cash payment rather than package of cash and stock worth slightly more at some future time).

164. See *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995) (holding that court may not substitute its judgment for board's judgment unless board's defensive response was preclusive or coercive or outside "range of reasonableness").

B. *Analyzing the Conrail/CSX Lock-ups Under the Entire Fairness Standard*

A Delaware court would examine the Conrail board's actions under the entire fairness standard set forth in *Weinberger*¹⁶⁵ only if Norfolk, *qua* stockholder of Conrail, succeeded in rebutting the business judgment rule presumption that, in making a business decision, the Conrail directors were disinterested and that they acted in an informed basis, in good faith and in the honest belief that their approval of the lock-up provisions was in Conrail's best interest or if Norfolk demonstrated that a majority of the Conrail board had a personal, business or financial interest in the proposed Conrail/CSX merger.¹⁶⁶

In this case, however, it appears unlikely that Norfolk would be able to rebut the business judgment rule or demonstrate that a majority of the Conrail board had a personal, business or financial interest in the Conrail/CSX merger. While Mr. LeVan, as President, Chief Executive Officer and Chairman of the Board, clearly had a personal and financial interest in the proposed merger, Norfolk did not allege that Conrail's remaining board members had an interest in the outcome of the proposed merger.¹⁶⁷ Furthermore, the pleadings may not be fairly characterized as having demonstrated, and the decisions of the district court did not address, whether the Conrail board acted in good faith or in an informed manner. For these reasons, the authors believe that a Delaware court would not conclude that the Conrail directors have the burden of establishing the entire fairness of the lock-up provisions.

C. *Analyzing the Conrail/CSX Lock-ups Under the Revlon Standard*

Finally, a Delaware court would consider whether the Conrail board had a duty under *Revlon* to act reasonably to seek the transaction offering the best value reasonably available to the stockholders. Since a board of directors will have *Revlon* duties only if the company is undertaking a transaction that will result in a sale or change in control of the corporate entity,¹⁶⁸ the threshold question for a Delaware court when reviewing this transaction is whether the proposed Conrail/CSX merger would constitute a sale or change of control.

165. *Weinberger v. VOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

166. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995); *Unitrin*, 651 A.2d at 1377 n.18; *Weinberger*, 457 A.2d at 711.

167. To the contrary, plaintiffs asserted (without contradiction by Conrail) that no board member, other than Mr. LeVan, is a current or former employee or member of the management of Conrail. See Memorandum Of Law In Support Of Motion To Dismiss Plaintiff's Complaint Pursuant To Rule 12(b)(6) For Failure to State A Claim For Which Relief May Be Granted.

168. See *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 48 (Del. 1994).

In general, the Delaware courts have concluded that a stock for stock merger will not trigger *Revlon* duties, provided that the control of the acquired corporation remains in a "large, fluid, changeable and changing market" and is not passed to anyone by virtue of the transaction.¹⁶⁹ On the other hand, the Delaware courts have held that *Revlon* duties will be implicated where the transaction in question shifts control of the corporation from its public stockholders to a controlling stockholder.¹⁷⁰ In this case, of course, since the proposed CSX/Conrail merger transaction includes both a stock for stock merger and a two stage cash tender offer, it is difficult to predict whether a Delaware court would conclude that Conrail's actions triggered *Revlon* duties.

On the one hand, a Delaware court might conclude that, despite CSX's accumulation of shares of Conrail, the proposed CSX/Conrail merger does not trigger *Revlon* because control of Conrail (and its successor entity) will be held by a fluid aggregation of public stockholders. While this position finds some support in Delaware law,¹⁷¹ it ignores the fact that CSX would be a controlling stockholder of Conrail immediately prior to the consummation of the proposed back-end merger.¹⁷² On the other hand, a Delaware court might conclude that since control of Conrail will pass to CSX, albeit temporarily, the duties imposed by *Revlon* will be implicated.

While the authors are unaware of any decision of a Delaware court that has considered whether *Revlon* duties would be triggered under the circumstances described above, the authors believe that it is likely that a Delaware court would conclude that *Revlon* duties would be implicated in this case. First, notwithstanding the fact that the Conrail stockholders will remain stockholders in a widely-held public company following the consummation of the proposed CSX/Conrail merger, it is nevertheless the case that it was the Conrail board's approval of the first two steps of the transaction—the two step tender offer and the granting of the stock option—that resulted in a change in control. Therefore, the authors

169. See *Time*, 1989 WL 79880, at *23.

170. See *QVC*, 637 A.2d at 48.

171. *Paramount Communications Inc. v. Time Inc.*, C.A. Nos. 10866, 10670 & 10935, 1989 WL 79880, at *23 (Del. Ch. July 17, 1989).

172. In its disclosure materials filed with the Securities and Exchange Commission, Conrail tacitly acknowledged that CSX would become a majority stockholder in Conrail if CSX consummated both cash tender offers and exercised its stock option. According to Conrail:

CSX has an option (the "Option") . . . to purchase 15,955,477 shares of Common Stock, exercisable under certain circumstances, including its purchase of Shares under the Tender Offer. If CSX acquires 40% of the Shares and the Option is exercised, the approval of the Merger by the Conrail shareholders would be certain.

See Proxy Statement of Conrail Inc. filed with the Securities and Exchange Commission pursuant to Section 14(a) of the Securities Exchange Act of 1934 on October 26, 1996.

believe that it is likely that a Delaware court would evaluate the Conrail board's decisions in connection with its recommendation and approval of these transactions under *Revlon*.

Second, since the Conrail stockholders are expected to receive cash for more than 40% of their shares (if the proposed CSX/Conrail merger is consummated), the authors believe that it is likely that a Delaware court would conclude that the Conrail board's decision to enter into the proposed CSX/Conrail merger would be subject to review under *Revlon*. There would appear to be scant justification for reviewing a merger under *Revlon* if the target company's stockholders will receive merger consideration which consists primarily of stock of the surviving widely-held public company, but includes a modest amount of cash. However, if a company's stockholders were to receive merger consideration which consists primarily of cash and a negligible amount of stock in the surviving widely-held public company, the authors believe that a Delaware court would review the board's decision to enter into the merger under *Revlon*, notwithstanding the fact that the stockholders retained a modest equity position in the surviving company. However, where approximately sixty percent of the consideration to be received by the target stockholders will consist of cash (as is the case with the Conrail stockholders), the authors believe that a Delaware court is likely to conclude that the board's decision to enter into such a merger transaction would be subject to review under *Revlon*.

If the Conrail board's decisions concerning the merger were subject to enhanced judicial scrutiny under *Revlon*, then a concern for fairness would preclude the Conrail board from using the lock-ups at issue to favor CSX over Norfolk.¹⁷³ In this case, however, it appears that Conrail utilized the lock-ups for precisely the opposite purpose—to foreclose further bidding. Thus, under the terms of the lock-up provision, the Conrail board was not permitted to consider or accept an offer of Norfolk, irrespective of the value of the offer, until December 31, 1998. Furthermore, the Conrail board was not permitted to amend its poison pill in order to allow Norfolk to acquire more than ten percent of the shares of Conrail (without triggering the poison pill) unless CSX agreed to such an amendment. Finally, both the termination fee and the stock option had the effect of significantly raising Norfolk's acquisition costs.

The lock-ups also had the effect of adversely affecting the value ultimately to be provided to the Conrail stockholders.¹⁷⁴ While Norfolk's offers did prompt CSX to increase its offering price, the lock-ups nevertheless prevented Conrail's stockholders from accepting Norfolk's

173. See *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182-85 (Del. .

174. See *QVC*, 637 A.2d at 49.

even higher offers. In fact, since the Conrail board contracted away its authority to accept a higher offer and its ability to amend its poison pill without the consent of third parties, the lock-ups had the further effect of preventing the Conrail board from being able to even consider such higher offers without the consent of CSX.

In light of the foregoing, the authors believe that it is likely that a Delaware court would conclude that each of the lock-ups utilized by Conrail and CSX—the termination fee, the stock option, the lock-out provision and the amendments to the poison pill—was invalid and unenforceable.¹⁷⁵ However, even if a Delaware court were not inclined to find any one lock-up provision, standing alone, to be unenforceable, the authors nevertheless believe that it is likely that the court still would conclude that the lock-ups are unenforceable because, in the aggregate, they have the effect of impeding the realization of the best value reasonably available to the Conrail stockholders.¹⁷⁶

V. CONCLUSION

In summary, the authors believe that a Delaware court, if presented with the same facts considered by the district court, would reach a very different legal result. Specifically, the authors believe that a Delaware court, unlike the district court, would conclude that the lock-ups discussed above are unenforceable under *Unocal* because they are unreasonable and disproportionate responses to the threat posed by Norfolk, and further that, because such lock-ups have the effect of impeding the realization of the best value reasonably available to the Conrail stockholders, they are invalid and unenforceable under the standards set forth in *Revlon*.

Ultimately, the authors' prediction of a different legal result is not surprising when one considers the public policies that appear to be reflected in the Pennsylvania and Delaware business corporation statutes. In Pennsylvania, the legislature has decided that corporate boards should consider whether a merger is in the best interest of the corporation and all of its constituencies (among which the stockholders are only one) and the board's decision with respect to such merger should remain relatively unfettered. On the other hand, in Delaware, the General Assembly has concluded that corporate boards should consider only whether a merger is in the best interests of the corporation and the stockholders and the Delaware Court of Chancery (and Supreme Court) have

175. See *Revlon*, 506 A.2d at 184; *QVC*, 637 A.2d at 50-51; *Mills Acquisition Corp. v. Macmillan, Inc.*, 559 A.2d 1261, 1286, 1288 (Del. 1988); *In re Holly Farms Corp. Shareholders Litig.*, C.A. No. 10350, 1988 WL 143010, at *6.

176. See *QVC*, 637 A.2d at 50.

the ultimate authority to determine whether the directors have been unflinchingly fair if they were on both sides of a transaction, whether they have responded reasonably and proportionately when their corporation is subjected to a hostile threat to corporate policy and effectiveness and whether they have obtained the highest value reasonably available to shareholders when selling or effecting a change in the control of the company.

VI. EPILOGUE

The authors prepared this Article in connection with the symposium on corporate law held by the University of Miami Law School in February of this year. As a result, this Article (and the authors' survey of Delaware cases) was largely completed prior to the conclusion of the Conrail/CSX/Norfolk matter. As a result, the Article does not reflect all of the final factual or legal developments in the case. However, in the following discussion, the authors have summarized the most significant and material developments in the battle for control of Conrail since that time.

On January 17, 1997, Conrail shareholders, who by this time consisted largely of institutional shareholders and professional investors, voted overwhelmingly against the proposal to amend the Articles of Incorporation of Conrail to "opt out" of the control transaction provisions of Subchapter 25E of the PBCL even though CSX owned 19.9% of the Conrail stock and a significant number of shares were held by Conrail employee benefit plans. Norfolk has stated that of the Conrail shares that were voted by shareholders, other than by CSX, over 90% opposed the opt out. At about this time, the Chair of the STB was quoted as expressing concerns about freight competition in the northeast and suggesting strongly to the parties that they resolve their differences by negotiation. At that point, CSX owned 19.9% of the Conrail stock and Norfolk had acquired 9.9% of the Conrail stock, each having made substantial investments in Conrail with no certainty that it would ultimately prevail in the contest.

In late February, Mr. Snow, CEO of CSX, reportedly urged Mr. LeVan, CEO of Conrail, that there be a tripartite negotiated resolution of the matter. Shortly thereafter, the Conrail board announced that it had authorized negotiations to this effect and in early March CSX and Conrail announced an agreement pursuant to which all of the Conrail stock would be purchased for cash at \$115 per share and that CSX and Norfolk would have the right to negotiate a "carve up" of the Conrail railroad system. In early April, CSX and Norfolk announced that they had agreed on an allocation of the Conrail assets to be acquired by each

party and a proportional allocation of the cash purchase price for the Conrail stock.

Some general observations are in order. In its first major test, the Pennsylvania anti-takeover statute was effectively validated from a judicial standpoint by the district court. However, in the end, the will of the stockholders (at least as they were constituted on January 17, 1997 and thereafter) prevailed. In the words of one observer, "ultimately, money talks."¹⁷⁷ As a result of Norfolk's intervention, approximately \$1.5 billion of additional cash (beyond the original CSX Proposal) will have been distributed collectively to the stockholders of Conrail. One can properly conclude that market forces prevailed, despite the district court's validation of the Pennsylvania statute. On the other hand, in what may be viewed as ironic, the Pennsylvania statute, which was clearly designed to provide a board of directors with an expanded arsenal of weapons to resist a hostile takeover by, among other things, permitting consideration of other, non-shareholder constituencies, may have itself contributed to the eventual outcome (which is required by the Delaware courts in a change of control scenario) of obtaining the best value reasonably available to the shareholders.¹⁷⁸

177. Andrew Cassel, *Antitakeover Law Enriched Conrail Shareholders the Pa. Measure Didn't Shield Jobs and Towns. The Irony, Some Say, is That it Boosted the Stock 65%*, PHILADELPHIA INQUIRER, Mar. 19, 1997, at C1.

178. See *Revlon*, 506 A.2d at 182.