Articles

WHOSE RULES SHOULD GOVERN TAKEOVERS: DELAWARE'S, THE ALI'S, OR MARTIN LIPTON'S?

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What rules should govern contests for corporate control? The takeover wave of the 1980's seems to have abated, but the question retains considerable currency. Commentators continue to debate the meaning of the leading Delaware cases.[1] The American Law Institute (ALI), without specifying the universe to which it was referring, recently observed that "[e]xisting judicial decisions do not offer a clear or consistent guide to directors in responding to unsolicited tender offers."[2] To remedy this situation, the ALI recommended an approach to evaluating takeover defenses that differs from Delaware law in several material respects.[3] Martin Lipton has proposed a radical restructuring of the corporate governance system designed to effectively abolish most uninvited takeover bids.[4]

The continuing debate over takeover bids and takeover defenses reflects a widely shared belief that, while changed economic conditions have led to a temporary decline in the pace of takeover activity, a new round of contests for corporate control inevitably will erupt in the not too distant future. The current hiatus in takeover activity, however, creates an opportune time for reflecting on the legal developments of the past decade. For the first time in years, no innovative transactional techniques, financial instruments or corporate gover-

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1. *See, e.g.*, Gordon, *Corporations, Markets and Courts*, 91 COLUM. L. REV. 1931 (1991); Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865 (1990).

2. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 11) 529 (April 25, 1991) [hereinafter ALI PRINCIPLES].

3. *See id.* § 6.02.

4. Mr. Lipton, an attorney who has specialized in helping companies defend against uninvited takeover bids, unveiled this proposal at a Practicing Law Institute program. *See* Lipton, *A Proposal for a New System of Corporate Governance: Quinquennial Election of Directors*, in PLI, INSTITUTIONAL INVESTORS: PASSIVE FIDUCIARIES TO ACTIVIST OWNERS (Sept. 24-25, 1990). He presented a more elaborate version in an article co-authored by one of his partners, Steven Rosenblum. *See* Lipton & Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991). For the sake of convenience, and also because Mr. Lipton first made the proposal in his own name, this Article refers to the proposal as Mr. Lipton's.

nance devices cry out for evaluation, no crush of recent takeover-related decisions awaits analysis by those seeking to discern the latest nuances in the courts' thinking.[5]

This Article presents an overview of case law developments since 1980. It demonstrates that Delaware's courts have succeeded in developing and applying a remarkably clear and consistent set of principles to contests for corporate control — principles that have allowed courts, in the main, to respond sensibly and pragmatically to a unique and difficult set of problems.

The Article also highlights the unique role Delaware's courts play in the development of American corporate law. Delaware courts were the only state courts to decide a substantial number of takeover-related cases during the 1980's, even though many non-Delaware companies were the targets of uninvited takeover bids and became parties to takeover-related litigation.[6] Federal courts decided almost all the lawsuits involving non-Delaware target companies, generally on the basis of principles developed by the Delaware courts.[7]

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5. As the text of this Article illustrates, a path-breaking takeover-related decision issued in virtually every year from 1980, when the Second Circuit decided Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980), to 1989, when the Delaware Supreme Court issued its written decision in Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989). In 1991, the most arguably significant takeover decision was NCR Corp. v. American Tel. & Telegraph Co., 761 F. Supp. 475 (S.D. Ohio 1991). However, it broke no new ground. *See infra* text accompanying notes 174-91.

6. Among the few reported state court decisions involving non-Delaware corporations were Kirschner Bros. Oil, Inc. v. Natomas Co., 229 Cal. Rptr. 899 , 185 Cal. App. 3d 784 (1986) (rejecting challenge to takeover defenses adopted by California corporation); Bank of New York Co. v. Irving Bank Corp., 142 Misc. 2d 145, 536 N.Y.S.2d 923 (Sup. Ct. 1988) (ruling New York corporation could not lawfully adopt "poison pill" as takeover defense); and Shoen v. Shoen, 167 Ariz. 58, 804 P.2d 787 (Ct. App. 1990) (rejecting challenge to takeover defenses adopted by Nevada corporation). *See also* Gries Sports Enter., Inc. v. Cleveland Browns Football Co., 26 Ohio St. 3d 15, 496 N.E.2d 959 (1986) (upholding challenge to takeover defenses adopted by Delaware corporation). The author served as a consultant to counsel for plaintiffs in *Shoen*. Issues in these lawsuits that involved questions of state corporate law clearly should have been decided in accord with the corporation laws of the states in which the target companies were domiciled. *See* CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 89 (1987) ("No principle of corporation law and practice is more firmly established than a State's authority to regulate [the internal affairs of] domestic corporations...."); RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 304 (1971).

7. Most such litigation also involved claims that one or the other of the parties had violated the Williams Act provisions of the Securities Exchange Act of 1934, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1988)), over which federal courts have exclusive subject matter jurisdiction. Securities Exchange Act of 1934, § 27 (codified at 15 U.S.C. § 77v(a) (1988)). Federal courts usually asserted pendent jurisdiction over related state law claims. State law claims that could have been presented to federal courts dealing with related federal claims in suits involving Delaware target companies, however, often were brought in Delaware state courts. *Compare* RP Acquisition Corp. v. Staley Continental, Inc., 686 F. Supp. 476 (D. Del. 1988) (district court passed on constitutional challenge to state anti-takeover law, noting that related litigation involving defensive tactics was proceeding in Delaware Chancery Court) *with* Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496 (7th Cir. 1988), *aff'd on other grounds*, 877 F.2d 496 (7th Cir. 1988), *cert. denied*, 493 U.S. 955 (1989) (noting that district court passed on challenges to both state anti-takeover law and poison pill defense deployed by target, a Wisconsin corporation). That litigants sought to have these issues resolved by Delaware state courts, rather than federal courts, may be evidence of the relatively high opinion corporate lawyers have of the Delaware courts' competence. *See*

In many other areas of corporate law, courts in other jurisdictions look to the Delaware Supreme Court for guidance when they face, as a matter of first impression, a problem the Delaware court already has considered.[8] But courts facing takeover litigation involving non-Delaware target companies were under no compulsion to follow Delaware law.[9] They could have rejected all or part of what Delaware courts had said if they considered Delaware's takeover jurisprudence to be unsound. With rare exceptions, though, courts in other jurisdictions embraced Delaware's approach to resolving takeover-related controversies.[10] Consequently, Delaware's approach has become the national approach to resolving takeover-related controversies.[11]

This makes all the more puzzling the American Law Institute's recent actions. At its 1991 meeting, the ALI disregarded this nationwide consensus and tentatively approved rules regulating takeover defenses that are considerably less lucid than Delaware law. The ALI's proposed rules, embodied in section 6.02 of the proposed Principles of Corporate Governance, appear to broaden the grounds on which directors may base decisions to block uninvited tender offers, and in other respects make it more difficult for shareholders to challenge directors' defensive actions.[12]

Martin Lipton's rejection of Delaware law is more clear cut and more emphatic. He suggests that corporate directors be elected for five-year terms and that hostile takeovers be barred between these quinquennial elections.[13]

This Article argues that the principles developed by the Delaware courts

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Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985).

8. This tendency led one court to describe the Delaware court as "the Mother Court of corporate law." Kamen v. Kemper Fin. Serv., Inc., 908 F.2d 1338, 1343 (7th Cir. 1990), *rev'd*, 111 S. Ct. 1711 (1991).

9. Erie R.R. v. Tompkins, 304 U.S. 64 (1938), at least as a formal matter, might be viewed as barring federal courts from developing innovative approaches to takeover-related problems. But the Second Circuit's takeover decisions of the early 1980's (*see infra* text accompanying notes 28-49) demonstrate *Erie* does not constrain federal courts from innovating in the absence of clearly controlling state law precedent.

10. *See infra* text accompanying notes 130-91. In contrast, several state legislatures have rejected Delaware's approach, at least to the extent of enacting laws that require or permit the directors of target corporations to consider the interests of both shareholders and non-shareholder constituencies when they respond to uninvited takeover bids. *See, e.g.*, ARIZ. REV. STAT. ANN. § 10-1202 (Supp. 1991); ILL. ANN. STAT. ch. 32, para. 8.85 (Smith-Hurd Supp. 1991); IND. CODE ANN. § 23-1-35-1(d),(f),(g) (Burns 1989); KY. REV. STAT. ANN. § 271B.12-210(4) (Michie 1989); ME. REV. STAT. ANN. tit. 13-A, § 716 (Supp. 1991); MASS. GEN. LAWS ANN. ch. 156B, § 65 (West Supp. 1991); MINN. STAT. ANN. § 302A.251(5) (West Supp. 1992); N.J. STAT. ANN. § 14A:6-1 (West Supp. 1991); OHIO REV. CODE ANN. §§ 1701.13(F)(7), 1701.59(E) (Anderson Supp. 1990); WIS. STAT. § 180.0827 (West Supp. 1991). *Compare* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (holding that desire to protect creditors is not a proper basis for preferring one competing bidder over another).

11. Johnson, *supra* note 1, explores political and other factors that thrust Delaware's court into this role.

12. Most such challenges are brought by the person seeking to gain control of a corporation. However, that person usually seeks to challenge takeover defenses in his capacity as a shareholder of the target company, the capacity in which he is owed fiduciary duties by the directors of the target company.

13. *See supra* note 4.

represent a better approach to regulating contests for corporate control than either the ALI's proposed standard or Mr. Lipton's proposal. To that end, the Article proceeds as follows. Part I describes summarily the courts' unsatisfactory, pre-1980 effort to employ directors' traditional duties of care and loyalty to resolve controversies involving hostile takeover bids. Part II recounts the partially successful attempt by the Second Circuit, in several early 1980's decisions interpreting New York and New Jersey law, to modify this traditional pattern of analysis. Part III describes the Delaware courts' creation of a new analytic framework for evaluating defensive actions, which began with its seminal decision in *Unocal Corp. v. Mesa Petroleum Co.*.[14] Part IV reviews cases in which other federal courts, dealing with contests for control of non-Delaware corporations, almost universally chose to follow Delaware's lead. Part V analyzes the ALI's proposed position on takeover-related issues. Part VI discusses some of the problems with Mr. Lipton's proposal for quinquennial election of directors. Part VII concludes that Delaware, other states, and the ALI all would be well advised to continue following the path blazed by Delaware's courts.

I. THE PROBLEMS POSED BY TAKEOVER BIDS

Courts used to face a difficult conceptual problem when shareholders challenged an action, approved by a corporation's directors, designed to anticipate or respond to an uninvited takeover bid (hereinafter a "defensive action"). The problem — whether to analyze the action under the duty of care or the duty of loyalty — arose because most defensive actions have a dual character. Those actions usually advance, at least arguably, some legitimate corporate objective, suggesting they should be analyzed under the duty of care. But those actions also make incumbent officers and directors more secure in their positions; the existence of this private benefit suggests a duty of loyalty analysis would be more appropriate.

The analytic dilemma arose from the fact that the choice of which duty governed usually determined the outcome of the litigation. If a court invoked the duty of care, it almost always would find the action was protected by the business judgment rule. Unless a shareholder could prove fraud, waste or that the board acted in bad faith, her challenge to the defensive action would fail. In contrast, if a court invoked the duty of loyalty, it usually would strike down the defensive action. Directors found it difficult to convince courts that defensive actions were fair since, by their nature, they provided benefits to the directors — continuing possession of their jobs — that were not available to the company's shareholders.[15]

Over a period of years, courts developed a primary purpose test, derived from the law relating to proxy contests, to determine whether the duty of care

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14. 493 A.2d 946 (Del. 1985). Part II will focus on the major themes developed in the Delaware cases. It will not treat many of the significant nuances of the Delaware case law, which, taken as a whole, are sufficiently complex to require treatise-length explication.

15. *See* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 824-31 (1981).

or the duty of loyalty was applicable to any given defensive action.[16] If directors' primary purpose in approving a defensive action was to entrench themselves, the court would invoke the duty of loyalty;[17] if directors had rebuffed a takeover bid because they disagreed with dissident shareholders or a hostile offeror about a question of corporate policy, the court would apply the duty of care.

The primary purpose test was fundamentally flawed, though, in that it provided courts with no reliable basis for determining directors' subjective motivation. It was here that the dual character of most defensive actions became problematic. Because uninvited takeover bids usually were made by persons dissatisfied with some aspects of incumbent directors' policies, some disagreement about a matter of business policy almost always existed. Yet defensive actions, by their nature, also almost always had some entrenching effect. The primary purpose test depended on the court's determination of which factor was predominant, but did not indicate how that determination was to be made.[18]

Cheff v. Mathes[19] partially resolved this dilemma, but also reduced the already limited efficacy of the primary purpose test. At issue was Holland Furnace Company's repurchase of a large block of its stock, at a premium price, from Motor Products Company, which was seeking control of Holland. Holland's directors sought to justify the repurchase by noting their disagreement with a major change in business policy Motor Products planned to adopt.[20] Rather than look at the circumstances in which the directors had acted to determine the motive for the defensive stock repurchase, the court pointed out that, whatever the directors' motive had been, the repurchase also served to protect the positions of Holland's managers. Consequently, the directors bore the burden of proving that the repurchase was "primarily in the corporate interest."[21]

However, after noting that Holland's board had a majority of disinterested directors, the court went on to hold that they could prove the repurchase was primarily in Holland's interest merely "by showing good faith and reason-

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16. *See* Hall v. Trans-Lux Daylight Picture Screen Corp., 20 Del. Ch. 78, 171 A. 226 (1934) (establishing primary purpose test for proxy contest expenses); McPhail v. L.S. Starrett Co., 257 F.2d 388 (1st Cir. 1958) (applying purposes/policy test to defensive stock issuance); Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (1960) (applying test to repurchase of stock from raider). In some earlier cases, courts had reacted considerably more skeptically to similar defensive actions. *See* Luther v. C.J. Luther Co., 118 Wis. 112, 94 N.W. 69 (1903) (striking down defensive issuance of stock); Elliott v. Baker, 194 Mass. 518, 80 N.E. 450 (1907) (same).

17. *See* Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (1962).

18. *See generally* Gilson, *supra* note 15.

19. 41 Del. Ch. 494, 199 A.2d 548 (1964).

20. *Id.* at 508, 199 A.2d at 556. Motor Products planned to eliminate Holland's large retail sales force. Although the court did not make much of the point, the practices used by Holland's sales force were under attack by the Federal Trade Commission as unfair and fraudulent. Holland Furnace Co. v. FTC, 269 F.2d 203 (7th Cir. 1959), *cert. denied*, 361 U.S. 932 (1960). As a result of these unfair sales practices, one of Holland's officers was sentenced to a six month prison term. *In re* Holland Furnace Co., 341 F.2d 548 (7th Cir. 1965), *aff'd sub nom.* Cheff v. Sackenberg, 384 U.S. 373 (1966).

21. *Cheff*, 41 Del. Ch. at 505, 199 A.2d at 554.

able investigation...."[22] This gutted the primary purpose test, as the result in *Cheff* makes clear. The court upheld the board's action because the directors' relatively cursory inquiries had produced some evidence that Motor Products would pursue business policies with which the Holland board disagreed. By allowing the directors to rely on this evidence, the court effectively transformed the primary purpose test into an application of the business judgment rule.

Courts continued to apply this business judgment version of the primary purpose test for several years. As a new wave of takeovers gathered momentum in the late 1970's and early 1980's, target companies were careful to have all defensive actions approved by disinterested outside directors. Courts regularly allowed those directors to rely on the business judgment rule to reject challenges to their decisions. *Panter v. Marshall Field & Co.*[23] probably represented the high (or low) point of such judicial protectionism.[24] Marshall Field's board had approved a number of questionable acquisitions, all of which had the "incidental" effect of creating antitrust obstacles to parties that had expressed some interest in acquiring Marshall Field. The court rejected a challenge to those decisions, reasoning that they had been made by outside directors, could be said to advance some valid business objective, and thus were covered by the business judgment rule.[25]

II. THE SECOND CIRCUIT'S APPROACH

Considerable dissatisfaction developed with the results of these cases. Commentators observed that target company directors had too much freedom to defeat hostile bids, which some viewed as the most effective accountability mechanism within the corporate governance system.[26] One federal appeals

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22. *Id.* at 506, 199 A.2d at 555. The court made clear that this burden was minimal by holding that the Holland directors' relatively limited inquiries about the reputation of Arnold Maremont, who controlled Motor Products, satisfied the requirement for a reasonable investigation.

23. 646 F.2d 271 (7th Cir.), *cert. denied* 454 U.S. 1092 (1981).

24. *See* Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAWYER 247, 249 n.8 (1989). Other cases in which courts approved questionable defensive tactics include Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757 (2d Cir.), *cert. denied*, 464 U.S. 1018 (1983) (approving defensive stock sale and lock-up option); Mobil Corp. v. Marathon Oil Co., [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,375 (S.D. Ohio) (holding "crown jewel" option lawful under Ohio law), *rev'd on other grounds*, 669 F.2d 366 (6th Cir. 1981) (holding option "manipulative" in violation of Williams Act); and Northwest Indus. v. B.F. Goodrich, 301 F. Supp. 706, 712 (N.D. Ill. 1969) (approving defensive acquisition and noting that "management has a responsibility to oppose [tender] offers which, in its best judgment, are detrimental to the company or its stockholders.").

25. The dissenting judge read *Panter* to so hold. *See* 646 F.2d at 299-304 (Cudahy, J., dissenting).

26. *See, e.g.*, Gilson, *supra* note 15; Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (arguing that managers should not be allowed to take any action to defeat hostile takeover bids); Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 VAND. L. REV. 1087 (1982) (suggesting courts develop federal standards to limit defensive tactics because state law review had become ineffective).

court went so far as to hold that certain defensive tactics which did not constitute a breach of state law fiduciary duties nonetheless violated the Williams Act's prohibition against manipulation.[27]

Other federal courts, stimulated by innovations developed by bidders and target companies that placed increasing strains on the existing doctrinal structure, began to reconsider how the primary purpose test best could be applied. The Second Circuit took the lead, crafting an approach to evaluating defensive actions that shifted the focus of inquiry from whether a defensive action had been approved by "disinterested" outside directors to when outside directors who had approved a defensive action should be considered "disinterested."

Treadway[28] initiated this change. Two companies were attempting to acquire Treadway. Treadway's board authorized the sale of a large block of stock to one of them, which impeded the takeover bid of Care, the other potential acquiror. In holding that the stock sale had been authorized by disinterested directors and consequently was protected by the business judgment rule, the court stressed that Treadway's defensive action, even if successful, would result in all but one of Treadway's directors losing their positions on the board.[29] This fact made clear that the directors were disinterested.

Crouse-Hinds Co. v. Internorth, Inc.[30] involved the obverse situation, one in which directors approved an action likely to result in their remaining in office. Crouse-Hinds was the target of an uninvited takeover bid by Internorth, one condition of which was that Crouse-Hinds not consummate a previously-negotiated merger with Belden Corp.. Rather than abandon the merger,

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Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), illustrates the confused state of the law. Chief Judge Seitz, a former Delaware Chancellor, wrote that the burden of justifying a defensive action will shift to a defendant if the plaintiff can show that the defendant's sole or primary motive was to retain control, but provided little guidance as to what a plaintiff must provide, short of "smoking gun" evidence, before a court will hold that she has made the requisite showing. *Id.* at 293.

27. *Mobil*, 669 F.2d at 366. For a description of how a comprehensive federal regulatory scheme could be based on the Williams Act provision on which the *Mobil* court relied, see Weiss, *supra* note 26.

The Supreme Court subsequently aborted *Mobil*'s implicit rejection of state law fiduciary standards, interpreting the Williams Act to be concerned solely with informational fraud. *See* Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985).

28. 638 F.2d 357.

29. The court observed:

> In nearly all the cases treating stock transactions intended to affect control, the directors who approved the transaction have had a real and obvious interest in it: their interest in retaining or strengthening their control of the corporation. It is this interest which causes the burden of proof to be shifted to the directors, to demonstrate the propriety of the transactions.

Id. at 382. The Treadway directors who approved the stock sale "expected that they would lose their positions as Treadway directors and would not be offered new ones" (*id.* at 383), so their decision to sell stock was protected by the business judgment rule.

Treadway was a New Jersey corporation, but the court did not base its decision entirely on New Jersey case law. *See id.* at 382.

30. 634 F.2d 690 (2d Cir. 1980). Crouse-Hinds, the target, was a New York corporation.

Crouse-Hinds entered into an exchange agreement with Belden designed to ensure that the merger would be completed.[31]

The court held that the possibility that the exchange offer would result in the Crouse-Hinds directors remaining in office was not sufficient, in the circumstances presented, to place the directors' decision outside the protection of the business judgment rule.[32] Because the directors' original approval of the Belden merger was protected by the business judgment rule, so was their decision to approve the exchange offer. The court found the directors' claim that the purpose of the exchange offer was to facilitate the previously negotiated merger to be "patently credible."[33]

Crouse-Hinds created considerable uncertainty. *Treadway* indicated that defensive actions which would not result in directors remaining in office would almost always be protected by the business judgment rule, but left unclear the status of defensive actions that allowed directors to keep their jobs. Would such actions be protected only in unique circumstances, such as those involved in *Crouse-Hinds*, where powerful evidence belied claims that directors had acted primarily to entrench themselves, or would courts allow directors to claim business judgment rule protection for any defensive action that arguably served some legitimate business purpose?

Norlin Corp. v. Rooney, Pace Inc.[34] substantially resolved this uncertainty. Norlin, faced with an uninvited takeover bid, issued substantial blocks of stock to a wholly-owned subsidiary and an Employee Stock Option Plan [ESOP], both of which were controlled by the Norlin board.[35] The newly issued stock, combined with stock directors already owned, gave board members control of forty-nine percent of Norlin and made a hostile takeover virtually impossible.

The court read *Treadway* to hold that directors who approve a defensive action that allows them to remain in office will be presumed to have an interest in the action sufficient to remove it from the coverage of the business judgment rule.[36] That meant Norlin's directors bore the burden of proving that the stock transfers were inherently fair. The court rejected the directors' claim that the

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31. *Id.* at 695-97. The exchange agreement contained standstill provisions that made it economically unattractive for Crouse-Hinds shareholders to vote against the merger. *Id.* at 696.

32. *Id.* at 704.

33. *Id.* at 703. The court also noted that the exchange offer did not entrench the directors by decreasing the effective voting power of any Crouse-Hinds shareholders. *Id.* at 703 n.21.

34. 744 F.2d 255 (2d Cir. 1984).

35. Norlin was a Panamanian corporation, and claimed that under Panama law its subsidiary could vote any Norlin stock it owned. The court held the case was governed by New York law, under which that stock could not be voted. *Id.* at 261.

36. *Id.* at 265. The court explained that in *Treadway*, the directors were allowed to rely on the business judgment rule because

> Care had failed to establish a conflict of interest on the part of Treadway's board. [The] opinion specifically noted evidence that Fair Lanes had been interested in merging with Treadway for a number of years, that all of Treadway's directors but one anticipated losing their positions if the merger with Fair Lanes were consummated, and that the merger was not merely a "sham or a pretext," but rather a viable business proposition.

stock transfers were necessary to give them time to provide "professional guidance" to shareholders about the course of action they should pursue,[37] stating it "stands our prior cases on their heads":

> We have never given the slightest indication that we would sanction a board decision to lock up voting power by any means, for as long as the directors deem necessary, prior to making the decisions that will determine a corporation's destiny. Were we to countenance that, we would in effect be approving a wholesale wresting of corporate power from the hands of the shareholders, to whom it is entrusted by statute, and into the hands of the officers and directors.[38]

Treadway and *Norlin*, viewed together, suggest that courts should evaluate defensive actions largely in terms of whether they allow incumbent directors to remain in office. Where they do, courts generally should find such actions were taken for purposes of entrenchment and, accordingly, are not protected by the business judgment rule. Only where a defensive action advances some well-established business objective, as was the case in *Crouse-Hinds*, should a court conclude that directors did not act to entrench themselves.[39]

The *Treadway/Norlin* approach represented an advance from the post-*Cheff* version of the primary purpose test, in that it provided for some meaningful judicial review of defensive actions that had been approved by outside directors. But the *Treadway/Norlin* test focussed on a variable — whether a defensive action would result in directors remaining in office — that often did not correlate well with whether the action helped or hurt a target company's shareholders. At times the test could be overinclusive, insulating from review questionable defensive actions that had been approved by directors who expected to lose their jobs. At times the test could be underinclusive, leading courts to invalidate defensive actions that protected target company shareholders simply because those actions also allowed directors to remain in office.[40] Subsequent decisions by courts in the Second Circuit attempted to deal with these problems of over- and under-inclusiveness by retaining the basic structure of the *Treadway/Norlin* test and modifying the business judgment rule and the inherent fairness test as they applied to defensive actions.

Hanson Trust PLC v. ML SCM Acquisition Inc.[41] involved competing efforts to acquire SCM by Hanson Trust and an alliance of SCM senior man

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Id. at 265 n.7.

37. *Id.* at 267.

38. *Id.* The court also observed that "[w]here, as here, directors amass voting control of close to a majority of a corporation's shares in their own hands by complex, convoluted and deliberate maneuvers, it strains credulity to suggest that the retention of control over corporate affairs played no part in their plans." *Id.* at 265.

39. *Norlin* made it clear that directors could not claim an action was fair simply because it gave them time to decide, on a schedule of their own choosing, whether, when, and under what circumstances a corporation should be sold. *See supra* text accompanying note 387.

40. For example, the action taken by Unocal's directors to protect shareholders from Mesa's coercive tender offer. *Unocal*, 493 A.2d 946. *See infra* text accompanying notes 52-54.

41. 781 F.2d 264 (2d Cir. 1986).

agers and Merrill Lynch. A committee of outside directors undertook to represent the interests of SCM and its shareholders. The committee, however, only negotiated with the management-Merrill Lynch alliance and eventually gave that group a lock-up option to purchase certain key SCM assets,[42] in exchange for their agreement to top, by a very small amount, Hanson Trust's most recent bid.

Under the *Treadway/Norlin* test, the committee's decision to grant the lock-up option appeared to be protected by the business judgment rule, since all committee members would lose their directorships if the alliance acquired SCM. The court held, however, that because the lock-up option benefitted SCM's senior officers, as well as Merrill Lynch, the committee's decision was subject to a "*heightened* duty of care."[43] The court examined very closely the process by which the committee decided to approve the lock-up option; it concluded that the committee had acted without sufficient study and had relied unduly on the advice of management and others.[44] Clearly the court's notion of a "heightened duty of care" represented a substantial deviation from the business judgment rule analysis that *Treadway/Norlin* otherwise would have required.[45]

The Second Circuit has not dealt directly with the other prong of *Treadway/Norlin* — how directors can meet the burden of demonstrating the inherent fairness of a defensive action that allows them to remain in office. However, *Tucker Anthony Realty Corp. v. Schlesinger*[46] indicates the court could be expected to modify the strict inherent fairness test. That case involved the fiduciary duties of a managing partner. The *Schlesinger* court read *Norlin* to suggest that where a committee of outside directors not otherwise affiliated with management approves an action, makes a good faith effort to simulate arm's-length negotiations in connection with that action, and approves the action only after reviewing all material facts, the court will not conclude that the action is unfair merely because the action allows committee members to retain their directorships.[47] District courts in the Second Circuit employed a similar version of the inherent fairness test in takeover cases decided before *Schlesinger*. They found defensive actions to be inherently fair even though the directors who approved them received a benefit — retention of their seats on

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42. A "lock-up option" is an option to purchase key assets of a target company at a favorable price. The grant of such an option generally makes a target unattractive to a competing offeror, as was the case in *Hanson Trust*. *Id.* at 266.

43. *Id.* at 276 (emphasis in original).

44. The court criticized the outside directors for having authorized a preclusive defensive action at a three-hour, late-night meeting, for having relied unduly on management's recommendations, and for not having asked more probing questions of the investment bankers and lawyers that the outside directors had retained to advise them. *Id.* at 275-76. One gets the sense, though, that the court would have been less critical of the process SCM's directors employed had it been more sympathetic to the action the directors took. Concern that the court based its decision on its disapproval of the directors' decision was the basis of Judge Kearse's dissent. *See id.* at 286 (Kearse, J., dissenting).

45. *See also* Terrydale Liquidating Trust v. Barness, 846 F.2d 845 (2d Cir.), *cert. denied*, 488 U.S. 927 (1988) (court carefully reviews directors' decision to liquidate trust that was target of hostile tender offer, even though liquidation resulted in directors losing their jobs).

46. 888 F.2d 969 (2d Cir. 1989).

47. *Id.* at 973-74.

the target company's board — that was not available to other target company shareholders.[48]

The Second Circuit's *Treadway/Norlin* test represented an advance over post-*Cheff* Delaware law, insofar as it allowed courts some scope to focus on the merits of defensive actions approved by boards with a majority of outside directors. But the *Treadway/Norlin* test remained problematic because of its reliance on the duties of care and loyalty, neither of which is well suited to evaluating defensive actions. *Hanson Trust* and *Schlesinger* reduced somewhat the importance of deciding which duty a court should invoke; *Hanson Trust* by limiting the protection afforded by the business judgment rule, and *Schlesinger* by reducing the stringency of the inherent fairness test. But the holdings of *Hanson Trust* and *Schlesinger* were not limited to takeover situations. Consequently, those cases also had the potential to create considerable confusion as to which version of the business judgment rule or the inherent fairness test a court should apply in cases not involving takeover bids.[49]

III. DELAWARE DEVELOPS A NEW APPROACH

The *Treadway/Norlin* test and most other takeover decisions issued in the early 1980's were based, at least arguably, on *Cheff* and other Delaware court decisions. But no challenge to a modern takeover defense reached the Delaware Supreme Court until 1985, when *Unocal Corp. v. Mesa Petroleum Co.*[50] was decided.[51] The decision in that case has proven to be the cornerstone of the Delaware courts' approach to evaluating defensive actions. Subsequent decisions elaborate on, but do not modify, the basic principles announced in *Unocal*.

A. The Unocal *Quartet*

Unocal arose when the Unocal Corporation used an unprecedented, and extremely powerful, defensive tactic to counter a hostile takeover bid by Mesa Petroleum.[52] Mesa had purchased fourteen percent of Unocal's stock in the open market and then announced a cash tender offer for an additional thirty-

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48. *See* Danaher Corp. v. Chicago Pneumatic Tool Co., 633 F. Supp. 1066 (S.D.N.Y. 1986) (decision to transfer stock to ESOP found to be fair, where ESOP was under active consideration long before tender offer was made and ESOP shares are not controlled by target company directors); British Printing & Communication Corp. v. Harcourt Brace Jovanovich, Inc., 664 F. Supp. 1519 (S.D.N.Y. 1987) (court reads *Norlin* as requiring application of inherent fairness test to recapitalization plan because target company directors will remain in office, but concludes plan is fair to target company shareholders).

49. Similar confusion about what standards apply in takeover situations led Judge Kearse to describe the law, prior to *Treadway*, as "something less than a seamless web...." *Treadway*, 638 F.2d at 382.

50. 493 A.2d 946 (Del. 1985).

51. Pogostin v. Rice, 480 A.2d 619 (Del. 1984), involved some takeover-related issues, but was essentially a suit for damages based on a claim that directors had an absolute duty to respond positively to any offer of a takeover premium.

52. In a case decided only a few months before *Unocal*, the Delaware Supreme Court had cited with apparent approval several decisions, including *Panter*, 646 F.2d at 271, that appeared to rely on the purpose/policy distinction. *See Pogostin*, 480 A.2d at 627. *Pogostin*, however, involved a claim that a board was obliged to accept any takeover bid offering shareholders a premium over market prices, not an attack on some action directed at frustrating such a bid.

seven percent at fifty-four dollars per share. Mesa said that if its tender offer succeeded, it would effectuate a second-step merger, in which Unocal's remaining shareholders would be forced to exchange their shares for risky subordinated debentures with a nominal value of fifty-four dollars. Unocal's board, which valued Unocal at seventy to seventy-five dollars per share, responded by offering to purchase up to forty-nine percent of all Unocal stock for seventy-two dollars per share in senior debt securities — an offer that was open to all Unocal shareholders other than Mesa.[53]

Unocal's decision to exclude Mesa from the self-tender obviously was designed to discourage Mesa's takeover bid, which made it difficult for Unocal to secure the protection of the business judgment rule. The exclusionary self-tender was unlikely to survive review under a fairness test, though, since it clearly discriminated against Mesa, Unocal's largest shareholder.[54]

The *Unocal* court, as is now well known, relied on neither of these standards. Rather, it announced a new and different approach to evaluating defensive actions, justifying its break with the past by noting "certain caveats" to the general principle that any board decision, including a decision to resist a takeover bid, is entitled to a presumption that it represents a valid exercise of directors' business judgment:

> Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.[55]

The court held that directors bear the burden of satisfying both parts of a two-part test before the a defensive action will be protected by the business judgment rule. The first part, which has limited substance, is rooted in *Cheff*: "[D]irectors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. However, they satisfy that burden 'by showing good faith and reasonable investigation....'"[56]

The second, more substantive part goes well beyond *Cheff*. Even when directors ascertain that a threat exists,

> [their] powers are not absolute. A corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available.... A further aspect is the element of

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53. *Unocal*, 493 A.2d at 949-51.

54. Other Unocal shareholders could exchange a majority of their shares for debentures worth $72, while Mesa could only retain its stock which, after the exchange offer, was expected to be worth about $35 per share. *Id.* Since the self-tender did not have the same effect on all Unocal shareholders, the company could be required to prove that no shareholder was prejudiced by the disparity. The court observed that "no case has ever sanctioned a device that precludes a raider from sharing in a benefit available to all other stockholders." *Id.* at 957.

55. *Id.* at 954. Later in its opinion, the court added that "our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs." *Id.* at 957.

56. *Id.* at 955 (citations omitted).

> balance. *If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.*[57]

The court mentioned three secondary factors that subsequent decisions treat as important. It emphasized that disinterested outside directors had made the decision to resist Mesa's offer and authorize the exclusionary self-tender.[58] Second, it pointed out that the self-tender had no impact on shareholders' other mechanism for ousting Unocal's directors — the corporate electoral process.[59] Finally, it observed that determination of whether a defensive measure is "reasonable in relation to the threat posed" could involve consideration of the following factors:

> [I]nadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of the securities being offered in the exchange.[60]

Initial reactions to *Unocal* focussed more on the court's approval of an unusually forceful defensive tactic than on the doctrinal content of the court's analysis.[61] *Moran v. Household International, Inc.*[62] highlighted the importance of *Unocal*'s doctrinal themes. *Moran*, which addressed the legality of a so-called poison pill, made clear that the two-part *Unocal* test, henceforth, would play a central role in the Delaware courts' review of defensive actions.[63] *Moran* also emphasized that Delaware courts would continue to attach considerable importance to whether a "threat" had been investigated, and a defensive action had been approved, by independent outside directors.[64] Finally, *Moran* reiterated the view that defensive actions are more likely to be considered rea-

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57. *Id.* (emphasis added). The court, applying this standard, held that Unocal's exclusionary self-tender was a reasonable response to Mesa's coercive tender offer. *Id.* at 956-57.

58. *Id.* at 955, 958.

59. "If the stockholders are displeased with the actions of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out." *Id.* at 959. Since the defensive tactic employed reduced the proportion of Unocal's shares owned or controlled by Unocal's management, the company also could have been taken over by another tender offeror.

60. *Id.* at 955.

61. *See, e.g.*, Weiss & White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CALIF. L. REV. 551, 578 (1987) ("The *Unocal* decision seemed ... to signal that the Delaware Supreme Court would allow corporate boards wide scope to resist hostile takeover bids.").

62. 500 A.2d 1346 (Del. 1985).

63.

> [I]n *Unocal* we held that ... "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed.... [T]hey satisfy that burden 'by showing good faith and reasonable investigation....'" In addition, the directors must show that the defensive mechanism was "reasonable in relation to the threat posed."

Id. at 1356 (quoting *Unocal*, 493 A.2d at 955) (citations omitted).

64. The court noted that a corporation's claim of business judgment rule protection "is materially enhanced, as we noted in *Unocal*, where, as here, a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards." *Id.*

sonable if they leave unimpaired the corporate electoral process and do not operate to preclude all uninvited takeover bids.[65]

Moran left unanswered, though, important questions about what kinds of actions, other than coercive tender offers, Delaware courts would allow a board to find represented genuine threats to corporate policy or effectiveness, and how closely courts would analyze whether actions taken in response to genuine threats were reasonable. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[66] provided some answers.

Most notably, *Revlon* established that when the sale or break-up of a company became inevitable, "[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[67] This holding represented a logical extension of the second part of the *Unocal* test. Once it was clear that a company would be sold, the only "threat" shareholders faced was the possibility they would receive less than the best price available. Only one response to that threat was reasonable — try to ensure they receive the best price.[68]

The *Revlon* court's evaluation of the Revlon board's actions also suggested that courts should scrutinize closely defensive actions directed at noncoercive bids. The board attempted to justify its decision to grant a lock-up option to one of two competing bidders, which effectively ended the auction for Revlon, as necessary to induce that bidder to top the other's best bid. The court, which presumably would have deferred to the directors' claim had the business judgment rule applied, instead concluded that granting the lock-up was unreasonable because the new bid represented only a small improvement over the competing bid already on the table.[69]

Revlon's directors, relying on the "other constituencies" language in *Unocal*, claimed the lock-up nonetheless was reasonable because the favored bidder had offered added benefits to certain Revlon noteholders to induce them not to sue Revlon and its directors. The court held this was not a factor the directors properly could consider.[70] Shareholders' interests were to be given primacy.

> Thus, when a board ends an intense bidding contest on an insubstantial basis, and where a significant by-product of that action is to protect the directors against a perceived threat of personal liability for consequences stemming from the adoption of

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65. The court noted that the directors' decision to deploy the pill "will not have a severe impact upon proxy contests and it will not preclude all hostile acquisitions of Household." *Id.* It added that any decision to rely on the pill to defeat an actual tender offer also would be subject to a second round of review under the *Unocal* standard. *Id.* at 1357.

66. 506 A.2d 173.

67. *Id.* at 182.

68. The Delaware Supreme Court analyzed the relationship of *Revlon* to *Unocal* in similar terms in Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1287 (Del. 1988).

69. *Revlon*, 506 A.2d at 182.

70. *Id.* at 184.

> previous defensive measures, the action cannot withstand the enhanced scrutiny which *Unocal* requires of director conduct.[71]

Revlon largely eliminated suspicions that *Unocal*'s two-part test was mostly empty rhetoric. The test appeared to have teeth. At least in a situation where a defensive action made inevitable a shift in control, or precluded any change in control, courts applying Delaware law could be expected to scrutinize that action closely.[72]

Mills,[73] the fourth case in what might be called the *Unocal* quartet, largely completed the Delaware Supreme Court's development of a new framework for analyzing defensive actions. *Mills* resolved many of the ambiguities that remained after *Unocal*, *Moran*, and *Revlon*.

The *Mills* court sharply criticized Macmillan's response to a series of uninvited takeover bids. Macmillan senior executives had provided outside directors with a "'pejorative characterization [of a first potential acquiror, which] ... served more to propagandize the board than to enlighten it.'"[74] In addition, "the only real 'threat' posed by [that offeror] ... was to the incumbency of the board," whose executives had used the "threat" as a "pretext ... 'to increase their, and their employees' ownership interest in the company.'"[75]

A number of findings — that management had propagandized the board, that management was financially interested in the actions it urged the board to approve, that management had not been completely candid with the board, and that the outside directors (who were aware of management's interest) had failed to assess independently and at arm's length the recommendations management had made — led the court to hold that "the challenged transaction must withstand rigorous judicial scrutiny under the exacting standards of entire fairness."[76] The same findings made it clear the challenged transactions would not pass either that test or the less exacting *Unocal* test.[77]

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71. *Id.*

72. *Revlon*'s holding that it was improper for directors to authorize a defensive action primarily to advance their personal financial interests was less striking, since it comported with well established principles involving directors' duty of loyalty.

73. 559 A.2d at 1261.

74. *Id.* at 1267 (quoting Robert M. Bass Group, Inc. v. Evans (*Macmillan I*), 552 A.2d 1227, 1232 (Del. Ch. 1988)).

75. *Id.* at 1271 & n.16 (quoting *Macmillan I*, 552 A.2d at 1243 & n.38). The court, explaining why it was proper for the trial court to draw these conclusions, quoted approvingly from *In re* Fort Howard Paper Corp. Shareholders Litigation, No. 88 Civ. 9991 (Del. Ch. Aug. 8, 1988), *reprinted in* 14 Del. J. Corp. L. 699 (1989):

> Rarely will direct evidence of bad faith — admissions or evidence of conspiracy — be available. Moreover, due regard for the protective nature of the stockholders' class action requires the court, in these cases, to be suspicious, to exercise such powers as it may possess to look imaginatively beneath the surface of events, which, in most instances, will itself be well-crafted and unobjectionable. Here there are aspects that supply a suspicious mind with fuel to feed its flame.

Mills, 559 A.2d at 1288 n.40 (citing 14 Del. J. Corp. L. at 719).

76. *Id.* at 1279.

77. The court found that Macmillan's outside directors had consistently and unquestioningly acquiesced in management's recommendations. It noted that a board of directors may rely in good faith upon information presented by officers and experts, but "it may

Emphasizing a point similar to one made in *Revlon*, the court also underlined its intent to give content to the concept of proportionality review. Macmillan's board had granted a lock-up option to a bidder affiliated with management, essentially ending all bidding for Macmillan. The court explained that this action failed *Unocal*'s proportionality test, as well as the more stringent test of inherent fairness. Since the lock-up ensured one of two competing parties would prevail, *Unocal* required that the board provide a stronger justification for its action, and the court scrutinize that justification more intensely than would be the case if the board's action had merely extended the contest for control of MacMillan.[78]

The *Unocal* quartet — *Unocal*, *Moran*, *Revlon* and *Mills* — established a framework of basic principles that Delaware courts have consistently applied to evaluate defensive actions. At the core of this framework is the two-part test first announced in *Unocal*: When a company takes a defensive action, the directors of the company bear the burden of proving that (1) they conducted a reasonable investigation which provided them with reasonable grounds to believe, in good faith, that a threat to corporate policy and effectiveness existed; and (2) the defensive action constituted a proportionate response to the threat posed.[79]

The *Unocal* quartet also established three corollaries to this basic test. First, great weight attaches to whether independent directors investigated a takeover bid, determined it posed a threat and decided to authorize defensive actions.[80] While a court could use the basic *Unocal* test to evaluate a defensive action approved by inside directors, in *Revlon* and *Mills*, the two cases where courts found decisionmaking directors were not truly independent,[81] they applied the more stringent standard of inherent fairness. This suggests, at a minimum, that Delaware courts will regard with considerable skepticism management directors' claims that they employed defensive tactics because of good faith concerns about shareholders' welfare, rather than their own interest in

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not avoid its active and direct duty of oversight in a matter as significant as the sale of corporate control. That would seem particularly obvious where insiders are among the bidders." *Id.* at 1281.

The court also found that insiders had violated their duty of candor, which the court characterized as "one of the elementary principles of fair dealing.... At a minimum, this rule dictates that fiduciaries, corporate or otherwise, may not use superior information or knowledge to mislead others in their performance of their own fiduciary obligations." *Id.* at 1283 (citing Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); Marciano v. Nakash, 535 A.2d 400, 406-07 (Del. 1987); Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 243, 70 A.2d 5, 7 (1949)). The fact that certain insiders had provided one bidder with information about the other's bid, but had not told the board of their conduct, violated their "rigorous affirmative duty of disclosure[,] ... was misleading and deceptive ... [and] was a fraud upon the board." *Id.*

The court noted that "any one of ... [these], standing alone, should easily foretell the outcome...." *Id.* at 1280.

78. *Id.* at 1287-88.

79. *Unocal*, 493 A.2d at 955.

80. *Id.* at 957.

81. Revlon's directors were not disinterested because their motivation, at least in part, was to avoid the possibility that they would be sued by bondholders. In addition, the court questioned whether a majority of directors was independent of Revlon's management. *Revlon*, 506 A.2d at 177 & 176 n.3. The Macmillan directors who formally approved the company's responses to hostile takeover bids, while unaffiliated with management, were not independent

retaining their jobs. Similarly, courts are not likely to find that the first element of the *Unocal* test has been satisfied unless a company's executives have been completely candid with the independent directors, providing them with all important information relevant to evaluating a takeover bid and the strategies being pursued in response to that bid.

Second, as to what constitutes a "threat" that justifies a board to authorize some defensive action, a coercive takeover bid, and the possibility that a coercive bid will be made, both clearly qualify. On the other hand, the prospect that a company's officers will be removed from their jobs, without more, does not.[82] Once it becomes clear that a company is to be sold or that control is to be transferred, the only meaningful threat is that shareholders will receive less than the best available price for their stock. In other situations, a board may be able to give some weight to the fact that a bid will jeopardize the interests of non-shareholder constituencies, such as employees or creditors, but only if so doing does not prejudice shareholders' economic interests.[83]

Finally, the *Unocal* quartet makes clear that determination of what constitutes a reasonable response to a takeover bid turns largely on the nature of the threat involved.[84] The courts will allow boards considerable latitude to counter coercive bids. Even there, though, and surely in other settings, a court is much more likely to find that a defense is reasonable if it leaves unimpaired the processes of corporate democracy and does not preclude all hostile tender offers. In contrast, when it seems inevitable that control will be transferred, the only reasonable response is to seek the best price available for the company's stock. Directors cannot employ tactics that have the effect of coercing shareholders into selecting one competing bidder over another, nor may they prematurely terminate an auction simply to ensure that a favored bidder will prevail. On the other hand, courts almost certainly will deem it acceptable for directors to employ tactics that are reasonably likely to ensure that shareholders receive the best available price for their stock.[85]

The *Unocal* quartet, on the other hand, leaves unresolved several important questions: When does a transfer of control become inevitable? What, other than a coercive bid, constitutes a cognizable threat? Can a board respond to a non-coercive bid by taking actions not directed at seeking a higher price for shareholders? When can a board reasonably act to terminate an auction? When, if ever, is it permissible for a board to employ defensive tactics that impede the processes of corporate democracy or make a company invulnerable to hostile takeover bids?

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because they allowed management directors, and advisors management had selected, to dominate the decisionmaking process. *Mills*, 559 A.2d at 1279.

82. *See Unocal*, 493 A.2d at 955.

83. For example, if someone like Frank Lorenzo, who has a history of adversarial relationships with airline employee unions, were to make a bid to buy a controlling interest in an airline, the board of the target arguably would be entitled to weigh the probability that employee relations problems would potentially have an adverse impact on the interests of shareholders who elected not to sell.

84. *Unocal*, 493 A.2d at 955.

85. *See, e.g., In re* Holly Farms Corp. Shareholders Litigation, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,349 (Del. Ch. March 22, 1989).

To analyze how courts applying Delaware law have dealt with all these questions would require book length treatment, involving analysis of the scores of Delaware takeover cases decided subsequent to *Unocal*. I will confine myself to reviewing two groups of cases. One consists of two post-*Unocal* decisions in which the Delaware Supreme Court has held takeover defenses were properly employed. The other includes recent decisions in which Delaware courts have passed on the propriety of defensive actions directed at impeding not tender offers but the corporate electoral process. Together, these decisions demonstrate the vigor of the principles developed in the *Unocal* quartet and illustrate how the Delaware courts have applied those principles in two highly significant contexts.

B. Cases Approving Defensive Actions

The Delaware Supreme Court has approved defensive actions in two important post-*Unocal* decisions. Those decisions suggest target companies retain considerable discretion to employ defenses in a variety of contexts, but only if they do so in a manner that comports with all basic principles developed in the *Unocal* quartet.

Ivanhoe Partners v. Newmont Mining Corp.,[86] decided before *Mills*, involved a tender offer by Ivanhoe Partners for a controlling interest in Newmont. The Newmont board, which had a majority of disinterested directors, found that Ivanhoe's bid was both coercive and inadequate. The board also feared that Ivanhoe's bid would free up Gold Fields, which held a large block of Newmont stock subject to a standstill agreement, to increase its position and gain control of Newmont without paying any control premium to Newmont's shareholders.

Newmont and Gold Fields agreed to engage in a series of transactions to deal with these threats. First, Newmont paid a large cash dividend to all of its shareholders, including Gold Fields. Then, Gold Fields used its share of the dividend to make open market purchases of enough Newmont stock to increase its interest in Newmont to 49.9 percent.[87] Finally, Gold Fields agreed to purchase no more Newmont stock, to attempt to elect no more than 40 percent of Newmont's directors, and to vote its stock in favor of nominees selected by independent directors for an additional 40 percent of the seats on Newmont's board, and in favor of senior managers for the remaining 20 percent of the seats on the board.[88]

The court stated that Newmont's board had a duty to oppose both Ivanhoe's coercive offer and the possibility that Gold Fields would acquire

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86. 535 A.2d 1334 (Del. 1987).

87. These purchases, made by means of a "street sweep," also precluded Ivanhoe from gaining control of Newmont, since Newmont's management also owned a significant amount of stock. *Id.* at 1337.

88. *Id.* at 1340.

control of Newmont without paying a control premium.[89] It held the board's actions to be "reasonable in relation to the threats posed"[90] because

> [t]he comprehensive defensive scheme ... accomplished the two essential objectives of thwarting the inadequate coercive Ivanhoe offer, and of insuring the continued interest of the public shareholders in the independent control and prosperity of Newmont. Under the circumstances, the board's actions taken by a majority of independent directors, are entitled to the protection of the business judgment rule.[91]

The three factors cited by the court to legitimate the board's actions all were consistent with the principles developed in the *Unocal* quartet. The board had a majority of independent directors. The board reasonably viewed Ivanhoe's potentially coercive tender offer as a threat. The board's actions in response to that threat were reasonable because they ensured that public shareholders, operating through the corporate electoral process, would continue to exert a potentially controlling influence over the make-up of Newmont's board.[92]

Some commentators interpret *Paramount Communications, Inc. v. Time, Inc.*[93] as undercutting the basic two-part test established by *Unocal*.[94] While the decision is not unambiguous, close analysis demonstrates that it is entirely consistent with the *Unocal* quartet.

Time had negotiated a stock-for-stock merger with Warner Communications. Shortly before Time's shareholders were scheduled to vote on the merger,[95] Paramount announced a $175 per share cash tender offer for all Time stock. Paramount's offer included several conditions, one of which was that the Time-Warner merger not be consummated. Since Paramount was offering a substantial premium over the market price of Time stock, the pen-

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89. *Id.* at 1345.

90. *Id.* Ivanhoe Partners was controlled by T. Boone Pickens. Some commentators believe the court's decision illustrates the proposition that the Delaware Supreme Court is unlikely to allow Mr. Pickens to gain control of a Delaware corporation through anything other than an all-cash, all-share, fully-funded takeover bid. *See* Note, *The Reasonableness of Defensive Takeover Maneuvers When the Corporate Raider is Mr. T. Boone Pickens*, 57 U. CIN. L. REV. 739 (1988).

91. *Ivanhoe Partners*, 535 A.2d at 1345.

92. That is, the directors elected by the public shareholders could combine with either Gold Field's nominees or the management directors to control the Newmont board.

93. 571 A.2d 1140.

94. *See* Gordon, *supra* note 1, at 1941-45; Freund & Ward, Jr., *What's "In," "Out" in Takeovers In Wake of* Paramount v. Time, Nat'l L.J., Mar. 26, 1990, at 22, col. 3; Sontag, Time *May Create Broad Takeover Defense*, Nat'l L.J., Mar. 12, 1990, at 14, col. 1; Mirvis, *What Triggers* Revlon*? Some New Answers*, N.Y.L.J., Dec. 3, 1990, at 5, col. 1 (all interpreting *Time* as endorsing "Just say no" defense). *See also* Norwitz, *"The Metaphysics of* Time*": A Radical Corporate Vision*, 46 BUS. LAW. 377 (1991) (interpreting *Time* as giving more weight to interests of non-shareholder constituencies); Johnson & Millon, *The Case Beyond* Time, 45 BUS. LAW. 2105, 2125 (1990) ("The logic of *Time* seems to imply the coming demise of *Unocal* and calls into question the normative basis of *Revlon*.").

95. Approval by Time's shareholders was not necessary under Delaware law because the proposed merger actually was between Warner and a wholly-owned subsidiary of Time.

dency of its offer made it likely that Time's shareholders would vote down the merger.[96]

Time's independent directors, relying on opinions prepared by their investment bankers, concluded that Time could be sold for more than $200 per share and that a combined Time-Warner entity also would be worth more than $200 per share. Rather than put Time up for sale, the directors decided to renegotiate Time's deal with Warner. They agreed to make a friendly cash tender offer for a controlling block of Warner stock and, assuming that offer was successful, to cause Time to acquire the remainder of Warner's stock in a second-step merger.[97]

Paramount (which had raised its bid to $200 per share) and other Time shareholders sued to enjoin Time's cash tender offer. The court first concluded that the original Time-Warner merger did not involve a transfer of control such as to place Time in a "*Revlon* mode," and then turned to the question of whether Paramount's offer constituted a threat to Time's shareholders.[98] It found that "the Time board reasonably determined that inadequate value was not the only legally cognizable threat that Paramount's all-cash, all-shares offer could present."[99] Other reasonably cognizable threats included the Paramount offer's potential to disrupt Time's previously negotiated merger and the business strategy it was designed to implement, as well as the risk that Paramount would never consummate its offer (which was subject to several other conditions) even if Time abandoned the merger with Warner.[100]

Time's directors argued that they had met their burden under *Unocal* by establishing their reasonable belief that Paramount's bid posed a threat to Time. The court rejected this claim. It reaffirmed that directors of a target company were obliged to satisfy both parts of the *Unocal* test, stating "even in light of a valid threat, management actions that are coercive in nature or force upon shareholders a management-sponsored alternative to a hostile offer may be struck down as unreasonable and non-proportionate responses."[101]

The court went on to find that Time's response suffered from neither of these defects. Control of Time remained in the hands of public shareholders; Time's acquisition of Warner "did not preclude Paramount from making an offer for the combined Time-Warner company" or from removing the no-merger condition from its existing offer.[102]

The *Time* court's conclusion that Paramount's bid represented a cognizable threat was entirely consistent with *Unocal*, which listed inadequacy of price, the timing of an offer, and the risk an offer would not be consummated as factors directors properly could consider when evaluating an offer and

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However, New York Stock Exchange rules required that Time seek shareholder approval of the merger because of the amount of stock that Time planned to issue. *See Time*, 571 A.2d at 1146.

96. *Id.* at 1148.

97. *Id.* The parties left in place other terms of the original Time-Warner agreement relating to governance of the combined corporation. *Id.*

98. *Id.* at 1153.

99. *Id.*

100. *Id.*

101. *Id.* at 1154.

102. *Id.* at 1155.

deciding on their response.[103] The court's analysis of Time's response also built on the view expounded in the *Unocal* quartet that a takeover defense probably will not be deemed reasonable if it denies shareholders all meaningful choices. Time's defense survived because it was approved by independent directors and, as construed by the court, neither entrenched incumbent management nor made it impossible for Paramount to acquire control of Time.

To read *Time* as undercutting *Unocal* and endorsing widespread use of the "Just say no" defense, one must treat as disingenuous the court's assertion that, even after acquiring Warner, Time still could become a target, and control of the corporation remained in the hands of public shareholders. Only by treating those arguments as makeweights can one fairly read *Time* to justify use of preclusive defensive tactics to defeat uninvited takeover bids.

The argument that the *Time* court was being disingenuous also requires one to discount the court's consistent emphasis — in the *Unocal* quartet and *Ivanhoe Partners*, as well as in *Time* — on the distinction between defenses that preserve shareholders' ability to use the mechanisms of corporate democracy to hold managers accountable and those that do not, and on the distinction between defenses that coerce shareholders or preclude all hostile bids and those that leave a company, at least in theory, subject to the market for corporate control.[104]

A better reading of *Time* is available. The court appears to have been very impressed (as any objective observer also would be) with the effort Time's management had devoted to planning and negotiating the merger with Warner; with the Time outside directors' determination, in the face of enormous pressure, to stick to their original plan and resist the Paramount bid; and with the possibility that those directors reasonably believed Paramount, after disrupting the Time-Warner merger, would rely on the other conditions in its bid to abandon its bid and leave Time's shareholders holding the bag.[105] Operating very much within the framework of the two-part *Unocal* test, the court was not willing to term unreasonable either the directors' belief that Paramount's offer threatened the well-being of Time and its shareholders, or the directors's decision to employ a non-coercive defense to counter that threat. In short, while

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103. *See supra* text accompanying note 60.

104. *See Time*, 571 A.2d at 1153. Some may find it difficult to reconcile this portion of the opinion with the court's suggestion that the Chancellor may have improperly substituted his opinion for that of target company boards of directors in City Capital Assoc. Ltd. v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988), and Grand Metro. P.L.C. v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988). I do not. The *Time* court went to great lengths to emphasize the continued vitality of the proportionality aspect of the *Unocal* test. Its remark about two chancery court decisions was made in dicta, and the court did not actually criticize the results in those cases, only the Chancellor's reasoning process "to the extent" it carried the Chancellor beyond the realm of his expertise. *Id.* Consequently, it is both possible and reasonable to read *Time* as consistent with the *Unocal* quartet and the results in *Interco* and *Pillsbury*. The reporters for the ALI Principles also view these decisions as consistent. *See infra* note 203 and accompanying text.

105. *Time*, 571 A.2d at 1152-53. Paramount had recently decided to concentrate its energies on entertainment-related businesses. A combined Time-Warner had the potential to provide Paramount with more formidable competition than would Time and Warner operating

Time may suggest that corporations have more latitude to respond to non-coercive bids than one might infer from *Revlon* and *Mills*,[106] *Time* surely does not signify that the Delaware court has abandoned its effort to develop a principled approach that allows courts to meaningfully review corporations' responses to uninvited takeover bids.[107]

C. Cases Applying Unocal *to Electoral Contests*

Several other Delaware decisions, in addition to *Time* and the *Unocal* quartet, emphasize the integrity of the corporate electoral process and confirm that Delaware courts look with extreme disfavor on defensive tactics that unduly limit or interfere with the shareholder franchise. The courts have allowed only the most modest sort of interference with the mechanisms of corporate democracy.[108]

In *Blasius Industries, Inc. v. Atlas Corp.*,[109] Chancellor Allen explained why Delaware courts more closely scrutinize actions that interfere with the shareholder franchise than actions designed to defeat tender offers.

> The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests....
>
> It has, for a long time, been conventional to dismiss the stockholder vote as a vestige or ritual of little practical importance.... [H]owever, whether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own....

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independently. At the least, it was not inconceivable that Paramount's intent was to disrupt the Time-Warner merger, but not to complete the acquisition of Time.

106. *Time* may be distinguishable from those cases, though, in that Time's directors were independent, while the directors of Revlon were held to be interested and those of Macmillan were found to have been dominated by interested directors.

107. Barkan v. Amsted Indus., Inc., 567 A.2d 1279 (Del. 1989), also is wholly consistent with *Unocal* and *Revlon*. *Barkan* affirmed the Chancery Court's approval of class actions challenging a management buyout of Amsted. One class member asserted that the settlement should not be approved because Amsted's board, which did not solicit competing bids after it became clear the company would be sold, had not met its *Revlon* obligations. The court observed that directors generally should attempt to canvas the market, but nonetheless affirmed the Chancellor's conclusion that it was unlikely the failure of Amsted's board to solicit competing bids had injured Amsted's shareholders. The absence of competing bids during the extended period Amsted was "in play," the history of management's efforts to obtain financing for its bid, which suggested that management's offer was at the high end of the fairness range, and the fact that management increased its final offer in response to pressure from a sophisticated investor who held a large amount of Amsted stock all supported this conclusion. *Id.* at 1287-88. These factors, together with the emphasis the court placed on management's fundamental obligation to obtain the best possible price for shareholders, provide strong support for the court's conclusion that the settlement under review was fundamentally fair.

108. Condec Corp. v. Lunkenheimer Co., 230 A.2d 769 (Del. Ch. 1967), and Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401 (Del. 1985), invalidated actions designed to strip control from shareholders who had already acquired majority ownership positions. Those decisions, while they might be described as involving "defensive tactics," can more accurately be described as involving clearly unlawful attempts to assert power by those who have lost it. This Article does not discuss those cases, which are wholly consistent with the cases discussed herein.

109. 564 A.2d 651 (Del Ch. 1988).

> ... Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority. Judicial review of such action involves a determination of the legal and equitable obligations of an agent towards his principal. This is not, in my opinion, a question that a court may leave to the agent finally to decide so long as he does so honestly and competently; that is, it may not be left to the agent's business judgment.[110]

At issue was an effort by Blasius to solicit consents to elect a majority of the Atlas board and then effectuate a major restructuring of Atlas. Atlas's directors believed in good faith that Blasius's restructuring proposal was imprudent and unrealistic. Shortly after Blasius began to solicit consents, the incumbent board named directors to fill two vacancies, making it impossible for Blasius to gain control by means of its consent solicitation.[111]

The court sympathized with the Atlas board's assessment of Blasius's restructuring plan but nonetheless invalidated the board's action. "The theory of our corporation law," the Chancellor pointed out, "confers power upon directors as the agents of the shareholders; it does not create Platonic masters."[112] The board was free to use corporate resources to try to convince shareholders that the Blasius plan was imprudent, but it could not take an action that effectively foreclosed shareholders' right to vote.

> A majority of the shareholders, who were not dominated in any respect, could view the matter differently than did the board. If they do, or did, they are entitled to employ the [electoral] mechanisms provided by the corporation law and the Atlas certificate of incorporation to advance that view.[113]

Blasius might be read as inferring that the court will invalidate any action that interferes with shareholders' exercise of their voting rights. Two subsequent Chancery Court decisions make clear that the prohibition on such interference is not quite so absolute.[114]

The first, *Shamrock Holdings, Inc. v. Polaroid Corp.*,[115] involved an effort by Shamrock Holdings, which had bought 9.6 percent of Polaroid's stock on the open market, to gain control of Polaroid by means of a proxy contest. Polaroid responded by selling fourteen percent of its stock to a newly-created

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110. *Id.* at 659-60 (footnotes omitted).

111. The Atlas board had seven members and an authorized strength of 15. Blasius was attempting to elect directors to fill the eight vacancies. If two of the vacancies were filled, Blasius would be able to elect no more than six directors if its solicitation succeeded. *Id.* at 654-55.

112. *Id.* at 663.

113. *Id.*

114. *See also* Allen v. Prime Computer, Inc., 540 A.2d 417 (Del. 1988) (holding that bylaw delaying for at least 20 days any stockholder action taken by written consent exceeded what is necessary for reliable and prompt ministerial review); Datapoint Corp. v. Plaza Securities Co., 496 A.2d 1031 (Del. 1985) (invalidating bylaw that imposed substantial delay on shareholder consent action; holding board is limited to providing for ministerial review of results of consent solicitation).

115. 559 A.2d 278 (Del. Ch. 1989).

ESOP, and a large block of voting preferred stock to a "White Squire" — an unaffiliated company that had signalled its inclination to support Polaroid's management. Shamrock, relying on *Blasius*, sought to have these stock sales enjoined.[116]

The court described *Blasius* as a logical extension of *Unocal* to the electoral sphere, "a specific expression of the proportionality test as applied to conduct that effectively precluded the election of directors."[117] It concluded, however, that while a more stringent test of proportionality might well apply to defensive actions taken for the purpose of interfering with the corporate electoral process, "such a standard would not appear to be applicable in this case."[118]

First, the actions approved by Polaroid's directors were "not preclusive." Even if the court attributed control of the ESOP and White Squire shares to Polaroid's board, the board would have only 33.4 percent of the votes. Shamrock owned 9.6 percent and probably could count on the support of arbitrageurs holding another 22 percent. Thus, public shareholders would determine who would prevail.[119]

Second, while agreeing with Shamrock that it was "appropriate to carefully scrutinize the purported justifications for transactions that clearly impact on the electoral process,"[120] the court found the Polaroid board's actions to be fair and reasonable. The board had begun discussing creation of an ESOP months before Shamrock appeared on the scene. The ESOP gave Polaroid employees control of the ESOP stock and the right to tender or vote that stock on a confidential basis. There was no evidence that "the employee stockholders constitute a monolithic block of voters who, for one reason or another, are constrained to vote with management."[121] In sum, the ESOP appeared to be a legitimate employee benefit program. Similarly, since the White Squire was not controlled by Polaroid and had no contractual obligation to vote its shares as recommended by Polaroid's board, the court was not prepared to enjoin Polaroid's sale of voting preferred stock.[122]

Polaroid supports the proposition that Delaware courts scrutinize very closely, but do not prohibit *per se*, defensive actions that directly impact the corporate electoral process. The court upheld the Polaroid directors' actions because they were part of a plan that had been under development, for non-control-related reasons, long before any electoral challenge arose; they improved management's electoral position but left the insurgents with a realistic chance to succeed; and, most importantly, they did not give the board control

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116. *Id.* at 285.
117. *Id.* at 286.
118. *Id.*
119. *Id.* The court also observed that the timing of the board's actions was "much less suspicious here than it was in *Blasius*." *Id.* The ESOP and the other challenged transactions all were being considered or reviewed, and some were being negotiated, weeks or months before Shamrock announced its proxy contest.
120. *Id.* at 290.
121. *Id.*
122. *Id.* at 290-91.

over any newly-issued shares, or even the right to learn how those shares had been voted.[123]

Stahl v. Apple Bancorp, Inc.[124] further clarifies Delaware law regarding defensive actions that affect the corporate electoral process. Apple Bancorp's board had chosen a record date for its annual meeting, but had not formally announced that date. Stahl, who owned thirty percent of Apple Bancorp's stock, informed the board he intended to conduct a proxy contest to gain control, and subsequently made a cash tender offer for all the bank's stock. The board deferred the record date and the annual meeting. Stahl, relying on *Blasius*, sued to require the board to set a record date and a date for the annual meeting.[125]

Chancellor Allen's opinion includes an excellent summary of the relevant principles of Delaware law, which also serves to illustrate its lucidity:

> [I]t is well established ... that where corporate directors exercise their legal powers for an inequitable purpose their action may be rescinded or nullified by a court at the instance of an aggrieved shareholder....
>
> Under this test the court asks the question whether the directors' purpose is "inequitable." An inequitable purpose is not necessarily synonymous with a dishonest motive. Fiduciaries who are subjectively operating selflessly might be pursuing a purpose that a court will rule is inequitable. Thus, for example, there was no inquiry concerning the board's subjective good faith in *Condec Corporation v. Lunkenheimer Company* where this court held that the issuance of stock for the principal purpose of eliminating the ability of a large stockholder to determine the outcome of a vote was invalid as a breach of loyalty....
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> *Lerman v. Diagnostic Data, Inc.* is a case that explicitly expresses the view that inequitable conduct does not necessarily require an evil or selfish motive. There the court held a bylaw invalid in the situation before it where that bylaw would have precluded a shareholder from mounting a proxy contest. The court referred to the fact that the bylaw "whether designedly inequitable or not, has had a terminal effect on the aspirations of Lerman and his group."
>
> Each of these cases dealt with board action with a principal purpose of impeding the exercise of stockholder power through the vote. They could be read as approximating a *per se* rule that board action taken for the principal purpose of impeding the effective exercise of the stockholder franchise is inequitable and will be restrained or set aside in proper circumstances.

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123. As was the case in *Time*, the *Polaroid* court seemed inclined to allow a little slack to directors who appeared to have acted in good faith and whose actions did not preclude the possibility that they could be removed from office.

124. 579 A.2d 1115 (Del. Ch. 1990).

125. *Id.* at 1120.

> Consistent with these authorities, in *Blasius* and in *Aprahamian* this court held that action designed primarily to impede the effective exercise of the franchise is not evaluated under the business judgment form of review.... These statements are simply restatements of the principle applied in *Schnell. Blasius* did, however, go on to reject the notion of *per se* invalidity of action taken to interfere with the effective exercise of the corporate franchise; it admitted the possibility that in some circumstances such action might be consistent with the directors [sic] equitable obligations. It was suggested, however, that such circumstances would have to constitute "compelling justification," given the central role of the stockholder franchise.
>
> Thus, *Blasius*' reference to "compelling justification" reflects only the high value that the prior cases had placed upon the exercise of voting rights and the inherently particularized and contextual nature of any inquiry concerning fiduciary duties. Neither it nor *Aprahamian* represent new law.
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> * * *
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> In no sense can the decision not to call a meeting be likened to kinds of board action found to have constituted inequitable conduct relating to the vote. In each of these franchise cases the effect of the board action — to advance or defer a meeting; to adopt a bylaw; or to fill board vacancies — was practically to preclude effective stockholder action or to snatch victory from an insurgent slate on the eve of the noticed meeting. Here the election process will go forward at a time consistent with the company's bylaws and with Section 211 of our corporation law. Defendant's decision does not preclude plaintiff or any other Bancorp shareholder from effectively exercising his vote....[126]

The court used the two-part *Unocal* test to evaluate whether Apple Bancorp's board had justified its decision to delay the annual meeting. First, the court made clear its view that a takeover at an inadequate price can represent a legitimate "threat" under the first part of *Unocal*, but the loss of a shareholder vote cannot — a distinction earlier cases support.[127] Then the court explained why the bank directors' action represented a reasonable response to Stahl's arguably inadequate takeover bid. Had Apple Bancorp held its annual meeting as originally planned, its shareholders effectively would have had to decide whether to accept Stahl's bid before the board had a reasonable opportunity to investigate alternative transactions. Because the board had to delay the

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126. *Id.* at 1121-23 (footnotes and citations omitted). The court concluded: "Plaintiff has no legal right to compel the holding of the company's annual meeting under Section 211(c) of the Delaware General Corporation law, nor does he, in my opinion, have a right in equity to require the board to call a meeting now." *Id.* at 1123.

127. *Id.* at 1124 ("[T]he prospect of losing a validly conducted shareholder vote cannot, in my opinion, constitute a legitimate threat to a corporate interest, at least if one accepts the traditional model of the nature of the corporation that sees shareholders as 'owners.'").

meeting in order to have time to pursue such inquiries, its decision did not interfere unreasonably with the corporate electoral process.[128]

Chancellor Allen concluded by relating the result in *Stahl* to the broad framework of Delaware corporate law, including the principles developed in the *Unocal* quartet:

> The essence of the *Unocal* form of review is a judicial assessment of the proportionality of a response to a threat. Here the response to the threat was extremely mild. Thus, in this instance one need not focus finely on how great was the threat posed by the prospect of an early vote, in order to conclude that the board's response in delaying the annual meeting to a later time (consistent with the company's bylaws and Section 211) was reasonable under *Unocal*. To delay a meeting once called would constitute a more substantial question of disproportionality. As one moves closer to a meeting date and closer to the announced conclusion of a contested election, attempts to postpone a meeting would likely require a greater and greater showing of threat in order to justify interfering with the conclusion of an election contest. Thus, in this way, the "enhanced" business judgment form of review of *Unocal* and the non-business judgment review of *Schnell, Condec, Aprahamian*, and *Blasius* come in the context of action arguably affecting the voting process, to resemble each other. *See Shamrock Holdings v. Polaroid Corp.*. This, of course, is not surprising. What is new in *Unocal* — judicial review of board decisions under an "objective" standard — is old in cases dealing with explicitly self-interested transactions or actions designed to affect the vote.[129]

IV. CASES INVOLVING A CHOICE OF LAW

Courts that decided takeover cases in which corporations chartered in states other than Delaware were targets faced an arguably difficult choice of law issue: should they rely on the *Treadway/Norlin* test or the principles developed in the *Unocal* quartet when reviewing defensive actions those target companies had employed? With only one exception, however, courts neither agonized over, nor even paid much attention to, this choice of law issue.[130] Rather, they consistently followed the Delaware approach, usually without discussing at any length other lines of authority on which they arguably could have relied.[131]

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128. *Id.*

129. *Id.* at 1124-25 (citation omitted).

130. *Shoen*, 167 Ariz. at 58, 804 P.2d at 787, was the exception. The court there stated it would follow *Norlin*, rather than Delaware law, but then relied on business judgment reasoning to approve a preclusive defensive action that had been approved by a board with a majority of interested directors. Because the author served as a consultant to plaintiffs in *Shoen* (*see supra* note 6), this Article will not comment further on that decision.

131. In addition to the *Treadway/Norlin* test, courts could have decided to rely on pre-*Treadway* cases that employ the primary purpose test. *See supra* text accompanying notes 16-25.

In most cases, the parties either agreed that Delaware principles controlled or the court found that courts in the target company's domiciliary state customarily looked to Delaware law for guidance. In *Dynamics Corp. of America v. CTS Corp. (Dynamics I)*,[132] for example, the parties agreed that Indiana law governed whether the target company's directors had violated their fiduciary duties when they adopted a poison pill, and "that Indiana takes its cues in matters of corporation law from the Delaware courts, which are much more experienced in such matters...."[133] In *International Insurance Co. v. Johns*,[134] when the parties failed to discuss the choice of law issue,[135] the court relied on Delaware law because "Florida courts have relied upon Delaware corporate law to establish their own corporate doctrines."[136] Other state courts follow similar practices.[137]

It may be that litigants and judges have paid limited attention to the choice of law issue because the choice between the *Treadway/Norlin* test and the *Unocal* quartet is more apparent than real. A brief review of the leading Second Circuit cases, viewed through the lens of *Unocal* and its progeny, suggests this is the case. In *Treadway*,[138] had *Revlon*[139] been available, the court could comfortably have upheld Treadway's stock sale as one element of a good faith effort to obtain the best available price for Treadway's shareholders.[140]

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132. 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987).

133. *Id.* at 253. *See also Amanda*, 708 F. Supp. at 1008 ("The parties agree that redemption of the [poison] pill is governed by Wisconsin law ... and that, in the absence of Wisconsin precedent, a Wisconsin court would look to Delaware case law for resolution of this issue.").

134. 874 F.2d 1447 (11th Cir. 1989).

135. *Id.* at 1458 n.19.

136. *Id.* at 1459 n.22. The court was ruling on the validity of a "golden parachute" plan. It held that whether it should use the two-part *Unocal* test to review the board's adoption of the plan depended on whether the plan was adopted as a takeover defense or an executive compensation measure. *Id.* at 1459-60.

137. *See, e.g.*, Georgia-Pac. Corp. v. Great Northern Nekoosa Corp., 728 F. Supp. 807, 809 n.3 (D. Me. 1990) (Maine courts look to Delaware law for guidance); Estate of Detwiler v. Offenbecher, 728 F. Supp. 103, 147 n.17 (S.D.N.Y. 1989) (Michigan courts look to Delaware law); Weiboldt Stores, Inc. v. Schottenstein, 94 Bankr. 488, 509 n.29 (N.D. Ill. 1988) ("Illinois courts have often looked to Delaware law for guidance in deciding previously undecided corporate law issues."). In A. Copeland Enter., Inc. v. Church's Fried Chicken, Inc., 706 F. Supp. 1283 (W.D. Tex. 1989), the court said it would follow a pre-*Unocal* Fifth Circuit decision, Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707 (5th Cir. 1984), that discussed the duties of target company directors under Texas law. However, in holding that a company properly used a poison pill as a gavel to advance an auction in which that company was up for sale, the court relied heavily on principles developed in Delaware cases and federal cases applying Delaware law, especially CRTF Corp. v. Federated Dept. Stores, Inc., 683 F. Supp. 422 (S.D.N.Y. 1988).

138. 638 F.2d 357.

139. 506 A.2d 173.

140. *See In re* RJR Nabisco Shareholders Litigation, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194 (Del. Ch. Jan. 31, 1991) (refusing to enjoin acquisition where directors of target made reasonable effort to conduct fair auction and obtain best price for shareholders); *Holly Farms*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at ¶ 94,349 (rejecting challenge to conduct of auction); Gray v. Zondervan Corp., 712 F. Supp. 1275 (W.D. Mich. 1988) (directors' decision to terminate auction held reasonable); Cottle v. Storer Communication, Inc., 849 F.2d 570 (11th Cir. 1988) (grant of lock-up option approved, where board reasonably believed bid, with face value of $2.00 per share less than competing bid, nonetheless, was better bid).

The *Crouse-Hinds*[141] court, had it been able to rely on *Time*[142] (to which *Crouse-Hinds* bears a startling resemblance), easily could have concluded that Crouse-Hinds' exchange agreement with Belden represented a reasonable and proportionate response to Internorth's tender offer. The court could have bolstered this conclusion by pointing to public shareholders' continued control of Crouse-Hinds and Internorth's ability to delete the merger condition from its bid.[143]

Similarly, the result in *Norlin*[144] would be the same under Delaware law. The precipitous quality of the Norlin board's decisions, the anti-democratic rationale on which the board relied, and the impact Norlin's defensive actions had on public shareholders' voting power all would be strong negatives in Delaware, as they were in New York.[145] As for *Hanson Trust*,[146] a court applying Delaware law surely would have enjoined the SCM board's decision to grant the lock-up option to the Merrill Lynch group. *Revlon*'s favorable discussion of *Hanson Trust* abundantly supports this conclusion.[147]

Moreover, had *Unocal* and its progeny been available to the Second Circuit when it decided these cases, its decisions would have more doctrinal coherence than the decisions the court actually rendered.[148] Instead of debating whether or not the business judgment rule applied, what version of that rule should be used, and how inherent fairness was to be defined, the Second Circuit could have focussed on the two more relevant questions that *Unocal* makes central: What sort of a threat, if any, did the bidders pose to the target companies and their shareholders?[149] Were the actions the target companies took reasonable responses to whatever threats were posed?[150] In sum, one can view the

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141. 634 F.2d 690.
142. 571 A.2d 1140.
143. Recall that the court emphasized these factors in *Time*. *See supra* text accompanying note 102.
144. 744 F.2d 255.
145. There is a striking similarity between the court's rhetoric in *Norlin* (*see supra* text accompanying notes 34-38) and in *Blasius*, 564 A.2d 651 (*see supra* text accompanying notes 109-14).
146. 781 F.2d 264.
147. *See Revlon*, 506 A.2d at 183. Judge Oakes, concurring in *Hanson Trust*, observed that "this would be, I think, a much easier case for the plaintiffs were Delaware's the governing law...." *Hanson Trust*, 781 F.2d at 285 (Oakes, J., concurring). He supported this observation by citing the chancery court decision in *Revlon* and the supreme court's oral affirmation of that decision. *Id.*
148. These observations imply no criticism of the Second Circuit's decisions. Most of the leading Second Circuit cases were decided before *Unocal*, and the federal courts' ability to innovate was limited by *Erie*. *See supra* note 9. Moreover, no New York or New Jersey state court has decided a major takeover case in recent years, so the Second Circuit was not sure what rule those states would employ. One fairly recent New York decision, Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979) (applying business judgment rule to decision to dismiss derivative suit), suggests that in New York, the business judgment rule may protect a wider range of decisions than in other states.
149. *Unocal*, 493 A.2d at 955.
150. *Id.* Courts still would consider the presence or absence of disinterested directors, the care those directors exercised, and the impact of defensive actions on shareholders' voting rights, but would treat those factors as evidentiary, rather than central. Note, though, that in every case discussed herein where a court has upheld a defensive action, the court found that a

Delaware cases as representing a refinement, rather than a rejection, of the Second Circuit decisions.[151] This may explain why federal courts, faced with takeover cases involving non-Delaware corporations, consistently have relied so heavily on Delaware law.

Significant controversy over whether to follow Delaware takeover law has been limited to one relatively narrow issue — whether directors lawfully can create shareholder rights plans, commonly known as "poison pills." The Delaware Supreme Court held in *Moran*[152] that Delaware law allows a company to issue rights that discriminate between holders of the same class of a company's stock. Shortly thereafter, a federal district court, interpreting a similar New Jersey statute, reached a contrary conclusion.[153] Several other courts subsequently interpreted other states' statutes to bar poison pill plans because they discriminated between holders of the same class of a company's stock.[154]

The poison pill cases are not particularly pertinent. They involve interpretation of specific statutory provisions, while this Article is concerned with defining directors' fiduciary duties. Nonetheless, it is interesting to observe that state legislatures have explicitly overridden all of the decisions holding poison pills to be unlawful.[155] Thus, in a sense, Delaware's approach has prevailed even on this issue.

When it came to reviewing defensive actions taken by non-Delaware target companies, federal courts almost always have relied on the principles developed by the Delaware courts. However, some courts have reached results that Delaware courts probably would not have reached.[156] *Dynamics Corp. of America v. CTS Corp. (Dynamics II)*[157] represents one such case. A board committee made up entirely of outside directors thoroughly considered the

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board or a committee controlled by (or comprised entirely of) independent, outside directors authorized that action.

151. Just as *Treadway* and *Norlin* involved efforts to employ the traditional care/loyalty dichotomy in the context of contests for corporate control.

152. 500 A.2d at 1351.

153. *See* Asarco Inc. v. Court, 611 F. Supp. 468 (D.N.J. 1985). The court reasoned that a statutory prohibition against discrimination between stock of the same class also barred discrimination between holders of that class of stock. Discrimination between holders lies at the heart of poison pill plans, which deter hostile takeovers by granting valuable rights to all shareholders other than one who has acquired a large position in the target company's stock without the permission of the target's board of directors.

154. *See* West Point-Pepperell, Inc. v. Farley Inc., 711 F. Supp. 1088 (N.D. Ga. 1988) (Georgia law); *Bank of N.Y.*, 142 Misc. 2d at 145, 536 N.Y.S.2d at 923 (New York law); R.D. Smith & Co., Inc. v. Preway Inc., 644 F. Supp. 868 (W.D. Wis. 1986) (Wisconsin law); Spinner Corp. v. Princeville Dev. Corp., [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,058 (D. Haw. Nov. 21, 1986), *vacated on other grounds*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,157 (D. Haw. Jan. 30, 1987) (Colorado law); Amalgamated Sugar Co. v. NL Indus., Inc., 644 F. Supp. 1229 (S.D.N.Y. 1986) (New Jersey law); Minstar Acquiring Corp. v. AMF Corp., 621 F. Supp. 1252 (S.D.N.Y. 1985) (New Jersey law).

155. *See Georgia-Pac.*, 728 F. Supp. at 810-11.

156. Of course, any assertion that a Delaware court would have reached some given result in a case decided by another court depends on a fundamentally subjective judgment. However, as described in Part III of this Article (*see supra* text accompanying notes 50-129), Delaware courts have issued relatively consistent and principled decisions in a large number of takeover cases. Consequently, one can, with relative comfort, suggest what results those courts would reach in post-*Unocal* cases, involving non-Delaware corporations, decided by federal courts.

157. 805 F.2d 705 (7th Cir. 1986).

alternatives open to CTS, which was the target of a partial bid and proxy contest. The committee decided the company should be sold, and determined in good faith that CTS's fair value was fifty dollars per share. The committee also adopted a poison pill. The pill had a one-year life and would terminate automatically if an offer of fifty dollars or more was made for all shares of CTS stock.[158]

The Seventh Circuit reversed a trial court finding that the committee had exercised due care when it adopted the poison pill, citing concerns about the independence of the committee's investment banker and the reliability of earnings projections on which the committee based its valuation.[159] The court refused to credit the argument, which Delaware courts uniformly have accepted, that a poison pill represents a reasonable response to a partial takeover bid. Instead, the court relied on an argument some academic commentators have made, which no Delaware court has endorsed, to the effect that the CTS directors should have considered the advantages of protecting shareholders' interests by adopting a "fair-price" amendment to the company's articles of incorporation.[160] Overall, one gets the sense that "skepticism concerning the propriety of poison pills,"[161] not Delaware law, dominated the court's reasoning.

Gelco Corp. v. Coniston Partners[162] is another deviant case. The court there indicated it was prepared to approve a restructuring plan that was potentially coercive to Gelco shareholders and would result in the Gelco board and its investment bankers together owning a majority of Gelco's stock. It attempted, unconvincingly, to distinguish a Delaware decision disallowing a similarly coercive defensive restructuring by noting that the Gelco board proposed its plan before the hostile bidder surfaced.[163] The court tried to play down the fact that Gelco's board arguably would obtain complete control by observing that Gelco's investment banker had no contractual obligation to vote its stock in support of management.[164]

Neither of these cases has great precedential significance, though. No later decision reflects the *Dynamics II* court's hostility toward poison pills.[165]

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158. *Id.* at 707.
159. *Id.* at 710-11, 713-16.
160. *Id.* at 716.
161. *Id.*
162. 652 F. Supp. 829 (D. Minn. 1986), *aff'd in part and vacated in part on other grounds*, 811 F.2d 414 (8th Cir. 1987).
163. *See id.* at 846, *distinguishing* AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986). The Delaware court was concerned primarily with the coercive aspect of the restructuring. That the Gelco board had previously considered such a plan did not make it any less coercive.
164. *Id.* at 847. *Polaroid*, 559 A.2d at 278, decided some years later, is consistent with *Gelco* insofar as it also attaches considerable weight to a board's prior consideration of a transaction that operates as a takeover defense, but *Polaroid* seemed to turn on the fact that after the defensive actions were taken, control of Polaroid would remain in the hands of its public shareholders. *See supra* text accompanying note 119.
165. Only one court, dealing with considerably different facts, has cited *Dynamics II* in support of a decision to enjoin a poison pill. *See* Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209, 230-31 (S.D. Ohio), *aff'd*, 815 F.2d 76 (6th Cir. 1987) (board adopted pill after 30 minute meeting). More typical is Desert Partners, L.P. v. USG Corp., 686 F. Supp. 1289 (N.D. Ill.

Gelco ultimately was decided on procedural grounds, so the court's discussion of Gelco's defensive action is only dicta.[166] Thus, *Dynamics II* and *Gelco* serve largely as reminders that with regard to takeovers, as in other areas of corporate law, Delaware courts typically use quite malleable language when they describe directors' fiduciary obligations.[167] That makes it possible for other courts, while ostensibly following Delaware law, to reach results that Delaware courts probably would not reach.[168]

Far more common are cases in which federal courts, reviewing takeover defenses employed by non-Delaware companies, have reached results that appear to be wholly consistent with the Delaware courts' decisions. *Edelman v. Fruehauf Corp.*,[169] for example, held Fruehauf's directors violated their *Revlon* duty to conduct a fair auction when they offered financial incentives to a management group and its investment banker to facilitate a leveraged management buy-out.[170] *Cottle v. Storer Communications, Inc.*,[171] relied on *Revlon* to approve the Storer board's decision to grant a lock-up option to KKR, one of two competing bidders, to induce it to make a bid that substantially exceeded the best previous competing bid.[172] Other courts have decided numerous other takeover cases in a manner that seems totally in tune with the Delaware courts' approach.[173]

1988) (refusing to enjoin adoption of poison pill by Delaware company that became target of hostile bid), a decision by a district court in the circuit that decided *Dynamics II*.

166. The district court held that Coniston, the bidder, had an adequate remedy in a suit for damages because its sole objective was to buy Gelco for liquidation purposes. *See* 652 F. Supp. at 844. Its decision was affirmed solely on this ground. *See* 811 F.2d at 417-18.

167. *See generally* Weiss & White, *supra* note 61 (this feature of Delaware corporate decisions best explains absence of stock market reactions to seemingly important doctrinal changes).

168. Levine v. Smith, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,908 (Del. April 9, 1991), illustrates this point. The court there said two federal district court cases upon which plaintiffs relied, *In re* Continental Ill. Sec. Litigation, 572 F. Supp. 928 (N.D. Ill. 1983), and *In re* General Motors Class E Stock Buyout Sec. Litigation, 694 F. Supp 1119 (D. Del. 1988), had misinterpreted language in earlier Delaware Supreme Court decisions. *Levine*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) at ¶¶ 99,486-99,487.

169. 798 F.2d 882 (6th Cir. 1986).

170. *Id.* at 886. The court also held that the directors violated their *Hanson Trust* heightened duty of care (*see id.*), thus, in effect, interpreting the *Unocal* quartet as refining, rather than overriding, the Second Circuit's modified *Treadway/Norlin* test. *See supra* text accompanying notes 138-51.

171. 849 F.2d 570 (11th Cir. 1988).

172. *Id.* at 576-77. The competitor subsequently made a nominally higher bid, but the court did not to change its mind. It accepted as reasonable the Storer board's conclusion that KKR's bid was better because it had a larger cash component and was "superior in terms of timing, tax consequences and financing." *Id.* at 577.

173. *See, e.g.*, Gray v. Zondervan Corp., 712 F. Supp. 1275 (W.D. Mich. 1989) (approving grant of lock-up to secure higher bid); Int'l Banknote Co. v. Muller, 713 F. Supp. 612 (S.D.N.Y. 1989) (relying on mix of Second Circuit and Delaware cases to enjoin bylaw that would impair dissident shareholders' ability to elect directors at annual meeting); Georgia-Pac. Corp., 727 F. Supp. 31 (upholding board decision on when to schedule referendum required by poison pill); *Offenbacher*, 728 F. Supp. 103 (holding board reasonably decided to sell company as a whole, rather than sell component parts); ER Holdings, Inc. v. Norton Co., 735 F. Supp. 1094 (D. Mass. 1990) (requiring board to hold regular annual meeting on date established by bylaws).

NCR Corp. v. American Telephone & Telegraph Co.[174] provides the most recent illustration of this point. AT&T, which was attempting to acquire NCR by means of a tender offer, also initiated a proxy contest. AT&T's primary objective was to remove all sitting NCR directors and elect AT&T designees as their replacements, an action that required the support of holders of eighty percent of NCR's outstanding stock. AT&T's secondary objective, if it was unable to remove the entire board, was to elect directors to the four seats on the board that were up for election in 1991.[175]

NCR's board had a majority of outside directors, most of whom were prominent figures from the worlds of business, finance and education. Those directors concluded that AT&T's tender offer was inadequate and refused to redeem NCR's poison pill. They also reacted to AT&T's proxy contest by approving creation of an ESOP to which a large amount of voting preferred stock would be issued.[176] NCR then sought a declaratory judgment that the ESOP was valid. AT&T countered by seeking to enjoin implementation of the ESOP.

NCR's ESOP was unique and rather complex. The plan provided that numerous employees each would automatically receive an economic interest in one share of convertible preferred stock, and also would be allowed to vote an additional 228 shares, representing a total of eight percent of the votes to be cast at NCR's shareholder meeting. The terms on which the preferred stock could be converted provided employees with a substantial economic incentive to vote against AT&T.[177] Those terms also created the potential for future sharp conflicts of interest between the beneficiaries of the ESOP and holders of NCR's common stock.

NCR's lawyers and investment bankers, not its employee benefits department, designed the ESOP. The plan was fully funded by NCR and brought no new capital into the corporation. Neither did the plan require employees to make any payments or concessions in order to participate. As a consequence, the plan seemed likely to impose substantial future costs on NCR, including possible large tax and accounting costs, while providing few benefits to the company.

The court analyzed the ESOP using the business judgment rule, the primary purpose test, and the two-part *Unocal* test. It concluded that the plan failed to pass muster under any of the three.[178] The court's opinion exemplifies how all three tests can be manipulated to support the same result; more importantly, it illustrates that analysis of a defensive action will be considerably more straightforward when a court relies on Delaware law.

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174. 761 F. Supp. 475 (S.D. Ohio 1991).
175. *Id.* at 491, 501. NCR's board was divided into three classes. Consequently, AT&T could elect only a third of the board in one year unless it removed all incumbent directors. AT&T wanted to elect a majority of NCR's directors so as to eliminate NCR's poison pill, which created a major obstacle to AT&T acquiring a controlling block of NCR stock.
176. *Id.* at 480.
177. *Id.* at 484.
178. *Id.* at 495.

NCR was a Maryland corporation, so the court first looked to Maryland law for guidance.[179] A 1964 Maryland Court of Appeals decision employed the primary purpose test to evaluate a defensive stock issuance;[180] other Maryland decisions suggested the business judgment rule created a presumption that any board decision, including a decision to authorize a defensive action, was made in good faith.[181] The court, rather than attempt to reconcile these two standards,[182] analyzed the ESOP under both. It concluded that the board's decision was not protected by the business judgment rule because the board had not acted in an informed capacity.[183] The court also held that the board's decision failed the primary purpose test because the ESOP was designed primarily to defeat AT&T's attempt to remove the board.[184] In support of these conclusions, the court discussed what NCR's management had and had not told the board about the details of the ESOP, what additional information the board should have sought,[185] and how the structure of the ESOP and the circumstances in which the board adopted it supported the inference that the principal purpose of the plan was entrenchment of the board.[186] The court had to bring in through the back door, so to speak, its conclusion that the ESOP constituted an inappropriate response to AT&T's takeover bid, largely because the plan made it virtually impossible for NCR's shareholders to vote the incumbent board out of office.[187]

The court then proceeded to analyze the ESOP under *Unocal*,[188] observing that a Maryland court might choose to follow Delaware law because "decisions of Delaware courts are often persuasive in the field of corporate law."[189] It concluded that NCR flunked both parts of the *Unocal* test. NCR

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179. *Id.* at 489.

180. Cummings v. United Artists Theatre Circuit, Inc., 237 Md. 1, 22, 204 A.2d 795, 806 (Ct. App. 1964).

181. *See NCR*, 761 F. Supp. at 490 (citing Zimmerman v. Bell, 800 F.2d 386 (4th Cir. 1986); Devereux v. Berger, 264 Md. 20, 284 A.2d 605 (Ct. App. 1971)).

182. For example, by reasoning that proof the board acted to entrench itself would rebut the presumption of good faith. *See id.* (using a similar line of reasoning with regard to the burden of production).

183. *Id.* at 491-92.

184. *Id.* at 496.

185. The court concluded that the board was not informed because "NCR's management ... failed to make the board aware of key information, and ... the board itself ... failed to ask questions, consider certain consequences or examine the plan with a critical eye." *Id.* at 495.

186. The court based this conclusion on "a series of factors, none of which, standing alone, is dispositive, but which, in the aggregate, allow for no other conclusion." *Id.* at 496. These included the timing of the plan, its size, the mirrored voting provision, the context in which the plan was discussed, the lack of input from the employee benefits department, and the structure of the preferred stock. *Id.* at 496-98.

187. Another example of the analytic difficulties posed by the business judgment and primary purpose tests is provided by the court's seemingly inconsistent holdings that NCR's board had not acted in bad faith (*id.* at 491), but had acted for the improper purpose of entrenching itself. *Id.* at 500.

188. The court may have pursued this alternative out of awareness of the analytic problems those tests pose — problems a Maryland court previously had noted. *See* Mountain Manor Realty, Inc. v. Buccheri, 55 Md. App. 185, 198 n.7, 461 A.2d 45, 53 n.7 (1983) ("We recognize that that latter determination — of assessing which among several business motivations (which may vary from director to director) was the principal or primary one — may not be an easy one to make.").

189. *NCR*, 761 F. Supp. at 499. The court noted that the parties had briefed the case under both Maryland and Delaware law. *Id.*

could not demonstrate that AT&T's bid "constituted a danger to 'corporate policy and effectiveness.'"[190] Second, even assuming NCR's board reasonably could have concluded that AT&T's offer was grossly inadequate and, as such, posed a danger to corporate policy and effectiveness, the ESOP did not represent a reasonable and proportionate response. The potential for conflict between the plan beneficiaries and NCR's other shareholders, the extent of the benefits the plan provided to employees without cost, the financial burden the plan would impose on NCR, and the fact the plan effectively foreclosed shareholders' ability to remove the board, all indicated the plan constituted an inappropriate response to AT&T's takeover bid.[191]

That the *NCR* court felt it necessary to analyze the ESOP under *Unocal*, even though the relevant Maryland cases employ a different test, provides yet another demonstration of the uniform respect American courts have evinced for Delaware's approach to reviewing defensive actions. *NCR* also illustrates why Delaware law is so well suited to that difficult task.

V. THE ALI CORPORATE GOVERNANCE PROJECT'S APPROACH

One might have expected the ALI's Corporate Governance Project would closely track Delaware law when it proposed standards for review of directors' decisions to authorize defensive actions, given the federal courts' virtually unanimous embrace of Delaware law.[192] However, although the ALI bases its approach on Delaware law, the proposed standard, codified in section 6.02 of the ALI Principles, deviates from Delaware law in several potentially important respects.[193]

The ALI Principles also address only one group of defensive actions — those that preclude unsolicited tender offers — and ignore others of considerable importance, such as actions that interfere with the corporate electoral process, that are embodied in bylaws that affect control,[194] and that involve reliance on state anti-takeover laws.[195] This contrasts with the ALI's approach to other

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190. *Id.*

191. *Id.* at 498. NCR attempted to overcome these arguments by claiming that its ESOP was similar to the plan upheld in *Polaroid*, 559 A.2d at 257, but the court found *Polaroid* to be distinguishable. It agreed that both the NCR and Polaroid plans were suspect, in that both potentially interfered with shareholders' voting rights. But, where Polaroid's plan served valid compensation objectives, NCR's plan "was adopted with the overwhelming purpose of thwarting AT&T's tender offer." *NCR*, 761 F. Supp. at 500. Where Polaroid's plan provided the company with a major influx of capital and required employees to make significant financial concessions, NCR's plan generated no new capital and provided stock to employees free of charge. Where Polaroid's plan left employees free to vote as they chose, NCR's plan was structured to coerce employees to vote against AT&T. Consequently, even applying the "lenient standards of *Polaroid*" (*id.* at 500), the NCR plan was invalid and unenforceable.

192. This expectation would be bolstered by the fact that Professor Ronald Gilson, a Co-Reporter of Part VI of the ALI Principles which deal with tender offers, has been one of the most articulate proponents of the approach Delaware's courts have adopted. *See, e.g.*, Gilson & Kraakman, *supra* note 24; Gilson, *supra* note 15.

193. The ALI's current position is set forth in ALI Principles, *supra* note 2, § 6.02.

194. *See id.* § 6.01, at 511-12.

195. *See id.* § 6.02, at 536.

areas of corporate governance, where the Principles address virtually all important issues.[196]

The ALI's caution appears to be a by-product of the controversy surrounding the entire subject of hostile takeovers.[197] The nature of that controversy, together with the ALI membership's rejection of the standard regulating defensive actions that the reporters originally proposed,[198] and the associated pressure the reporters must have felt to develop a politically viable compromise proposal, may help explain the problematic character of the ALI's proposed standard.[199] That standard lacks the coherence of Delaware's case law and creates a number of serious problems of interpretation.

The ALI's basic approach is to limit directors' authority to approve defensive actions: "The board of directors may take an action that has the foreseeable effect of blocking an unsolicited tender offer, if the action is a reasonable response to the offer."[200] This standard embodies the second, more meaningful part of the *Unocal* test — proportionality review.[201] The official Comment explains that *Unocal* and its progeny provide a more suitable framework for evaluating defensive actions than does either the business judgment rule or the primary purpose test.[202] However, the Comment does not persuasively justify other aspects of the ALI's proposed standard that involve deviations from the rules developed by the Delaware courts.[203]

Three provisions are potentially significant: section 6.02(b)(1), which allows directors to consider whether a tender offer, "if successful, would

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196. Part III-A of the Principles even sets forth *recommendations* of corporate practice for boards and their committees. ALI Principles, *supra* note 2, Part III-A.

197. The Introductory Note to Part VI states: "Part VI does not reflect a judgment on the economic, social and political issues posed by hostile takeovers." *Id.* at 499. In 1989, ALI Director Geoffrey Hazard mentioned the "deep divisions within the financial, business and legal communities concerning the long-run approach to a regime of takeover regulation" by way of explaining why the ALI Principles address only the corporate governance roles of shareholders and directors. ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Discussion Draft No. 2) ix-x (April 20, 1989). He did not, however, explain why the Principles address so few of the takeover-related decisions directors make.

198. *See* ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 10) § 6.02 (April 16, 1990).

199. Lyman Johnson argues that the Delaware courts have succeeded in developing a relatively lucid set of rules, in part, because they must operate through an adjudicatory, rather than a political, process. Johnson, *supra* note 1.

200. ALI PRINCIPLES, *supra* note 2, § 6.02(a), at 528-29 (cross-reference omitted).

201. *See id.* § 6.02, at 531 ("§ 6.02 is intended to be consistent with the so-called *Unocal* test ... — namely, whether ... the defensive measure adopted was reasonable in relation to the threat posed"), 533 ("the review accorded would be similar to that apparently given by the Delaware courts in applying the Unocal [sic] 'reasonable response' standard.").

202. *See id.* § 6.02, at 531-32.

203. Given the Comment's favorable assessment of *Unocal*, as well as the Reporters' assertion "that the results in the *Interco*, *Pillsbury*, *Anderson*, *Clayton* and *Polaroid* cases, as well as the result in the [*Time*] case, are consistent with the principles stated in § 6.02" (*id.* § 6.02, at 562), it is hard to credit the Comment's opening observation that "[e]xisting judicial decisions do not offer a clear or consistent guide to directors in responding to unsolicited tender offers." *Id.* § 6.02, at 529. This statement creates a false sense of uncertainty in the law. Perhaps its goal is to obscure the ALI's failure to justify, other than on political grounds, the Principles' rejection of Delaware decisions that have received virtually unanimous acceptance in other jurisdictions.

threaten the corporation's essential economic prospects";[204] section 6.02(b)(2), which suggests directors can properly take account of the "interests [of] groups (other than shareholders) ... if to do so would not significantly disfavor the long-term interests of shareholders";[205] and section 6.02(c), which assigns to a person challenging a tender offer defense "the burden of proof that the board's action is an unreasonable response to the offer."[206]

At first blush, section 6.02(c) appears to be the most troublesome. This provision is flatly inconsistent with *Unocal*'s requirement that directors bear the burden of proving that a defensive action was reasonable.[207] The ALI attempts to justify this deviation by offering the circular argument that section 6.02(c) "reflects the premise that credence should be given to the determinations made by directors...."[208] It makes no other effort to refute the *Unocal* court's widely-credited observation that directors should bear the burden of proving a defensive action is reasonable "[b]ecause of the omnipresent specter that a board may be acting in its own interests, rather than those of the corporation and its shareholders...."[209] Neither does the ALI explain why directors' decisions to block tender offers should receive any more credence than do shareholders' decisions to sell their shares.[210]

Concerns about this recommendation may be alleviated somewhat by the ALI's discussion of how a plaintiff can meet her burden of proof. After pointing out that non-coercive defenses which provide shareholders with alternatives, and defenses that protect shareholders from coercive partial tender offers generally should be permitted, the Comment observes:

> On the other hand, where the plaintiff has made a prima facie showing that the directors' action was not in the best interests of the corporation and its shareholders, the directors who took the preclusive action are in the best position to know the facts ... and the directors must then come forward with evidence supporting their conclusion, although the plaintiff will bear the ultimate burden of persuasion on the point.[211]

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204. *Id.* § 6.02(b)(1), at 528.
205. *Id.* § 6.02(b)(2), at 528.
206. *Id.* § 6.02(c), at 528-29.
207. The ALI acknowledges this inconsistency. *Id.* § 6.02, at 531.
208. *Id.* § 6.02, at 532. *See also id.* § 6.02, at 549.
209. *See supra* text accompanying note 55. The manner in which boards of many companies attempted to defeat takeover bids after *Unocal* was decided hardly add to one's sense of confidence that boards can be counted on to do the right thing. *See, e.g., Revlon*, discussed, *supra*, at notes 66-72 and accompanying text; *Mills*, discussed, *supra*, at notes 73-78 and accompanying text. *Cf.* Allen, *Independent Directors in MBO Transactions: Are They Fact or Fancy?*, 45 BUS. LAW. 2055, 2062-63 (1990) ("My intuition is that the jury is still out on the question whether the special committee device works well enough, often enough, for the law to continue to accord it weight.").
210. *See* ALI Principles, *supra* note 2, § 6.02, at 536-37:
> Shareholders normally have the right to sell their shares, free of any restrictions, to any person who wishes to purchase their stock. An action taken by the board that interferes with that right ... goes well beyond the usual board function ... and needs special justification....
211. *Id.* § 6.02, at 555-56.

This explanation, though not a model of clarity, suggests that a plaintiff will meet her initial burden of production by introducing evidence that a board action will foreseeably preclude shareholders from accepting a non-coercive tender offer.[212] At that point, defendant directors will be required to produce evidence sufficient to convince the court that their action was a reasonable response to the tender offer.[213] Because, as the Comment points out, the directors will possess most of the relevant facts, and because how the directors' action affects shareholders is not likely to be in dispute, who bears "the ultimate burden of persuasion" may not matter a great deal.

Note the conditional nature of this conclusion. Whether relieving directors of the burden of persuasion matters a great deal will depend in large part on the nature of the ultimate question a court is required to decide. If the court must compare the impact a defensive action will have to the objectively ascertainable impact of a tender offer on a corporation and its shareholders — that is, whether the price bid is fair and whether the offer is coercive — the evaluative process should be relatively straightforward, and who bears the burden of persuasion generally should not matter a great deal. But if the court must consider more subjective factors, the ALI's recommendation that plaintiffs bear the burden of persuasion becomes considerably more worrisome. The more nebulous the factors a court must evaluate, the harder it will be for a plaintiff to convince the court that the directors' decision to take defensive action was unreasonable.

This shifts the focus of analysis to section 6.02(b), which authorizes directors to consider two essentially subjective factors when they respond to an uninvited tender offer — whether the offer "would threaten the corporation's essential economic prospects," and whether a defense designed to protect non-shareholder groups "would not significantly disfavor the long-term interests of shareholders."[214] Some glimmerings as to how the ALI intends section 6.02(b) to be interpreted, not all of them reassuring, can be garnered from the Comment. It makes clear that the reference in section 6.02(b)(1) to an offer that would "threaten the corporation's essential economic prospects" is directed at offers that directors conclude would saddle their companies with too much debt.[215] The Comment does not explain, though, why a target company's board

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212. This follows from the Comment's apparent equation of "the directors who took the preclusive action" and "a prima facie showing that the directors' action was not in the best interests of the corporation and its shareholders." *Id.* § 6.02, at 555.

213. The situation would then be similar to one where a court relies on the primary purpose test. The business judgment rule creates a presumption that directors' actions are valid. Evidence that a defensive action entrenches directors serves to rebut this presumption. At that point, directors must demonstrate that they acted in good faith and for the benefit of shareholders. If, and only if, they make such a showing will the plaintiff have to persuade the court that the directors acted primarily for the purpose of entrenchment. *See NCR*, 761 F. Supp. at 489-91 (discussing burden of proof under business judgment rule and primary purpose test). It seems curious, though, that the ALI's proposal regarding the burden of proof in takeover litigation will effectively replicate the dynamics of the primary purpose test, to which the ALI has expressed considerable antipathy.

214. ALI PRINCIPLES, *supra* note 2, § 6.02(b), at 528.

215. *Id.* § 6.02, at 546.

has any legitimate reason to be concerned about the impact post-takeover debt will have on that company, at least where the offeror is prepared to purchase all the company's stock for cash. Excessive debt may lead to losses for those who lend to the offeror, but it would be more than curious for the ALI to authorize directors to sacrifice the interests of target company shareholders in order to protect an offeror's lenders.[216] To be sure, excessive debt also may create problems for employees or other constituencies of a corporation, but section 6.02(b)(2) authorizes directors to consider the interests of those groups. Consequently, it remains unclear whether section 6.02(b)(1) is devoid of content, or whether it serves some more nefarious purpose.

One possibility, not specifically negated by the Comment, is that section 6.02(b)(1) creates a huge loophole in a provision that otherwise seems designed to restrict directors' authority to block unsolicited tender offers. Whenever a tender offer is made that relies on substantial debt financing, directors should find it easy to locate a reputable investment banker who will be prepared to opine that the debt associated with the offer will "threaten the target company's essential economic prospects."[217] If courts were to treat such opinions as sufficient to justify preclusive defensive actions, section 6.02(b)(1) would work a major, unwelcome change in the law. Directors would then be able to block tender offers made by all but the most solvent bidders.[218]

Since section 6.02(b)(1) clearly could be construed to allow this result, one must hope that either the ALI or the courts will reject this interpretation.[219] One basis for doing so would be to read section 6.02(b)(2) as implicitly limiting the scope of section 6.02(b)(1).[220]

Subsection (b)(2) authorizes directors to take account of the interests of non-shareholder constituencies, but only if so doing will not significantly disfa-

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216. *See id.* § 6.02, at 538 (§ 6.02 imposes no obligation on directors to consider interests of holders of preferred stock or debt.).

217. This prediction is based, in part, on the frequency with which investment bankers have been prepared to characterize as inadequate tender offers involving very large premiums. *See, e.g., Mills*, 559 A.2d at 1261; *Time*, 571 A.2d at 1140. *See also* Allen, *Investment Bankers' and Judicial Review of Corporate Action to Defeat Hostile Takeovers: Comments on Chapter 6*, in THE BATTLE FOR CORPORATE CONTROL: SHAREHOLDER RIGHTS, STAKEHOLDER INTERESTS, AND MANAGERIAL RESPONSIBILITIES 131, 132-34 (A. Sametz ed. 1991) [hereinafter BATTLE FOR CORPORATE CONTROL]. The ALI increases the risk that such opinions will be easily obtainable by providing no elucidation of what a corporation's "essential economic prospects" are or when an increase in debt will place them in jeopardy.

218. Target company directors might find it difficult to argue both that an offer was inadequate and that the offer, if successful, would saddle the target company with too much debt. On the other hand, where most of a company's shareholders are prepared to accept an offer, courts are not likely to be persuaded that the directors' determination of inadequacy is reasonable. *See Pillsbury*, 558 A.2d at 1049. Directors thus may be more inclined to base their opposition to an offer on concern about excessive debt, since no action shareholders are authorized to take will produce evidence that the directors' belief is unreasonable.

219. Although section 6.02 was provisionally approved at the ALI's 1991 meeting, the reporters and the council retain the ability to propose changes in either the black letter or the Comment.

220. To proceed in this fashion, the ALI would have to amend, or a court would have to ignore language in section 6.02(b)(2) to the effect that directors may consider the interests of non-shareholder groups "in addition to the analysis under § 6.02(b)(1)." ALI PRINCIPLES, *supra* note 2, § 6.02(b)(1), at 528.

vor shareholders' long-term economic interests. The ALI's illustrations of situations where directors properly can rely on this provision suggests its scope is limited. Directors are allowed to act where a company's charter includes the goal of maintaining a clean environment or insuring the well-being of communities in which the company operates[221] — provisions found in the charters of few business corporations. Absent such a charter provision, directors are authorized to protect groups other than shareholders only if the economic burden on shareholders will be slight.[222]

Section 6.02(b)(2), it should be recognized, represents the reporters' and the Council's response to the membership's rejection at the 1990 annual meeting of a proposed standard that made no mention of non-shareholder groups. The illustrations and section 6.02(b)(2)'s limitation that directors can consider only the interests of non-shareholder groups "with respect to which the corporation has a legitimate concern"[223] suggest the reporters' intent is that this new provision not make much of a change in current law.[224]

VI. MARTIN LIPTON'S PROPOSAL

Martin Lipton has suggested a more radical restructuring of the corporate governance system, designed to free managers from the ever-present threat that their companies will become targets of uninvited takeover bids. This threat, Mr. Lipton postulates, has caused the managers of America's public corporations to pursue short-term thinking and neglect long-term planning to such a degree that "the health and vitality of our entire economy is at risk."[225] To remedy these ills, Mr. Lipton advances a plan with five major components. He would:

> [1] replace annual elections of directors with quinquennial elections; [2] bar nonconsensual changes in control between elections; [3] provide major stockholders with direct access to the corporate proxy machinery ...; [4] provide for a detailed five-year report, which would be independently evaluated by an outside advisor, analyzing the corporation's prior five-year performance and setting forth its prospective five-year plan; and [5] tie significant management compensation awards, as well as significant penalties, to the corporation's performance against the five-year plan.[226]

Coming at a time of revolutionary economic change in the Soviet Union

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221. *Id.* § 6.02, at 541.
222. *Id.* § 6.02, at 550-51 (Illustration 7).
223. *Id.* § 6.02(b)(2), at 528.
224. For a thoughtful discussion of the problems posed by constituency statutes, see Sommer, *Whom Should the Corporation Serve? The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33 (1991).
225. Lipton, *supra* note 4. The rhetoric in Lipton & Rosenblum, *supra* note 4, is considerably more muted, but the authors still blame hostile takeovers for the unhealthy prevalence of "short-termism" in American managers' thinking. *See* Lipton & Rosenblum, *supra* note 4, at 189.
226. Lipton & Rosenblum, *supra* note 4, at 190.

and Eastern Europe, one's first suspicion about Mr. Lipton's proposal, with its emphasis on five-year plans, is that it represents an elaborate spoof. But though much in Mr. Lipton's proposal could be termed laughable, if judged by the standards customarily applied to serious scholarship,[227] no reason exists to believe Mr. Lipton intended it as a joke. Consequently, this Article will attempt a sober explication of the proposal's more significant weaknesses.[228]

The threshold problem posed by Mr. Lipton's argument is that his premise depends on a straw man. Mr. Lipton contrasts what he says should be the goal of the corporate governance system, "the creation of a healthy economy through the development of business operations that operate for the long term and compete successfully in the world economy,"[229] with a model that seeks to conform corporate conduct to stockholder wishes and protect hostile takeovers.[230] The postulated "model," however, bears no resemblance to the existing legal regime,[231] nor does any reputable commentator, academic or otherwise, argue that protecting hostile takeovers should be a *goal* of the corporate governance system. Debate has centered on what value hostile takeovers have as a *means* for promoting the system's ultimate goals,[232] which encompass both "conforming corporate conduct to stockholder wishes" and "developing

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227. Although Messrs. Lipton and Rosenblum published their proposal in a prominent law review, they seem to have a pejorative view of academic work. This is suggested by their critical references to "*academic* literature," "[*a*]*cademic* writers," and "*academic* analysis" in the opening section of their article. *See id.* at 187 (emphasis added). Indeed, they use the adjective "academic" six times in the first four paragraphs, all in contexts evidencing their disagreement with the works they mention. *Id.* at 187-88. In contrast, when Lipton and Rosenblum discuss academic work that supports their thesis, they describe it as a "body of economic literature" (*see id.* at 198), not a "body of academic literature." Lipton and Rosenblum, however, make little effort to engage points of view different than their own or to explain away data that does not support their conclusions.

228. Mr. Lipton has written previously about hostile takeovers. *See* Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1 (1987); Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities—An Update*, 40 BUS. LAW. 1403 (1985); Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 BUS. LAW. 1017 (1981); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979). He has consistently argued that managers' decisions to resist hostile bids should be given great deference. One is tempted to view his proposal as the most recent and most extreme incarnation of that theme. However, this Article will discuss the proposal on the merits, without additional references to related arguments in Mr. Lipton's earlier writings.

229. Lipton, *supra* note 4, at 189.

230. *Id.*

231. As Mr. Lipton himself acknowledges, *see id.* at 190-91 & n.6 (observing that Chancellor Allen and the Delaware Supreme Court have "demonstrated a keen understanding of corporate governance issues and the ramifications of judicial decisions on the business and policies of corporations.").

232. *See, e.g.*, Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982) (debating whether law should impose duty on managers to facilitate auctions or should bar all defensive actions). Professor Gilson, in his article highlighting the role takeovers play in the corporate governance system, argues that takeovers are important largely because of the weakness of other devices available to promote the accountability of corporate managers. *See* Gilson, *supra* note 15. Mr. Lipton clearly understands that most academic commentators view takeovers not as the best possible governance device, but as one useful component of a multi-faceted system of corporate governance. *See* Lipton & Rosenblum, *supra* note 4, at 201-02 & nn.43, 44.

business operations that operate for the long term and compete successfully in the world economy."[233]

These goals are not inconsistent. A corporation's stockholders represent a continuing body, not simply the holders of its stock at some given moment. Today's stockholders may wish to sell at a premium over current market prices, but the only potential purchasers are people prepared to hold the stock tomorrow. Current stockholders must appreciate, if they think rationally, that decisions which reduce the firm's ability to compete tomorrow (i.e., over the long term) will lead to a reduction in the price prospective purchasers will be prepared to pay, and thus will injure current stockholders.[234]

Consequently, while Mr. Lipton's observation that American managers are unduly preoccupied with short-term results probably is on target, factors other than fear of hostile takeovers more likely explain their behavior.[235] American managers may find it difficult to identify long-term investments with positive present values because the cost of capital in the United States has been relatively high.[236] Alternatively, American managers may rely on capital bud-

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233. Surely, Mr. Lipton is not arguing against a system in which shareholders would be able to vote on all business decisions or to hold managers liable for any business decisions that lead to losses. Those who would facilitate takeovers premise their arguments, in part, on shareholders' very limited ability to influence managers' business decisions. *See* Gilson, *supra* note 15; Easterbrook & Fischel, *supra* note 26.

Mr. Lipton, at times, appears to suggest the existing governance system is flawed because it takes insufficient account of the interests of non-shareholder constituencies. *See* Lipton & Rosenblum, *supra* note 4, at 202-15. However, he proposes to increase the power of institutional shareholders, not that of other constituencies, and characterizes constituency statutes as "at best a stopgap measure." *Id.* at 215. Consequently, it is difficult to know what to make of his expressions of concern. The concern itself has some merit. I have elsewhere suggested how the corporate governance system could be restructured to better accommodate the interests of non-shareholder constituencies, in part by overcoming managers' frequent propensity to ignore those constituencies' interests. *See* Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse*, 28 UCLA L. REV. 343, 418-34 (1981).

234. Lipton and Rosenblum cite economic studies that call into question certain aspects of the efficient capital markets hypothesis (*see* Lipton & Rosenblum, *supra* note 4, at 198-99), but none of those studies question this stock valuation dynamic. In fact, Andrei Shleifer, a co-author of one of the studies Lipton and Rosenblum discuss, has co-authored another recent study which suggests managing for the short-term rarely represents a rational response to the threat of hostile takeovers. *See* Shleifer & Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148 (Papers & Proc. May 1990). No proponent of takeovers claims that all takeovers will be profitable. Bidders, as well as managers, may miscalculate or make unwise investment decisions. As Lipton and Rosenblum no doubt appreciate, all business decisions involve some risk of failure.

235. Professors Gilson and Kraakman point out that Messrs. Lipton and Rosenblum "neither offer empirical support for their proposition [that managers focus on the short term to avoid hostile takeovers] nor refer to the empirical studies that fail to find evidence of short term behavior [by institutional investors]." Gilson & Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 882 n.68 (1991). It is possible that managers have responded irrationally to the threat of takeovers, but that would hardly serve to justify radically revamping the corporate governance system.

236. Professors Gilson and Kraakman note that this is a standard explanation for why American managers have been less willing than Japanese and German managers to make investments that will only pay off in the long term. *See id.* That situation may be changing. *See* Farrell, *The U.S. Has a New Weapon: Low-Cost Capital*, BUS. WEEK, July 29, 1991, at 72.

geting techniques that lead them systematically to underestimate the impact development of new technologies will have on their ability to remain competitive.[237] Or, American companies may employ compensation and promotion practices that encourage managers to place too much emphasis on short-term results.[238] Each of these explanations could account for the behavior that troubles Mr. Lipton; none of them has much to do with hostile takeovers.[239]

Even if one accepts, for the sake of argument, Mr. Lipton's claim that hostile takeovers are a major cause of the problems many American corporations face, his proposal seems fatally flawed.[240] Rather than eliminate takeovers, his scheme seems likely to encourage them. Mr. Lipton would continue to allow "raiders" to make uninvited takeover bids, subject primarily to the requirement that a bid must coincide with a corporation's quinquennial election of directors.[241] A raider could purchase up to ten percent of a company's stock at any time without the consent of the target's board.[242] If the raider purchased more than five percent of the stock or stock valued at more than five million dollars, it would gain automatic access to the company's proxy statement for the purpose of nominating a slate of directors.[243] The company then would be required to pay all the raiders' proxy solicitation expenses, up to the amount incumbent directors spend.[244] Moreover, management would be barred from initiating litigation challenging the accuracy of the raider's proxy

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237. *See* Barwise, Marsh & Wensley, *Must Finance and Strategy Clash?*, HARV. BUS. REV., Sept.-Oct. 1989, at 85. For example, managers may erroneously assume that sales and earnings will remain constant absent investments in new technologies. Instead, sales and earnings are lost to competitors who make such investments. The resulting decline in returns generated by the firm's fixed capital represents a cost that those making the investment decision should have taken into account.

238. *See* Weiss, *supra* note 233, at 364-66.

239. Of course, managers may jeopardize their companies' long-term interests by devoting too much time, energy and resources to hostile takeover of other companies. *See* Porter, *From Competitive Advantage to Corporate Strategy*, HARV. BUS. REV., May-June 1987, at 43 (reviewing data indicating most acquisitions subsequently are divested); Weiss, *The Board of Directors, Management, and Corporate Takeovers: Opportunities and Pitfalls*, in BATTLE FOR CORPORATE CONTROL, *supra* note 217, at 35, 43-49 (discussing studies that suggest hostile takeovers are unlikely to be profitable for acquiring firms).

240. Many will find it difficult to take seriously claims that the problems being experienced by America's money center banks, or by companies in basic industries such as steel, automobiles and consumer electronics, are due primarily to the threat of hostile takeovers. Yet, that is what Mr. Lipton suggests:

> We have lost our place as the world's leading financial power. In many basic industries we are no longer competitive in world markets. If we do not solve the problems and reverse the trends [hostile takeovers cause] we will bequeath a declining standard of living to our future generations.

Lipton, *supra* note 4.

241. *Id.* ("If someone wishes to combine a hostile tender offer with an attempt to facilitate the offer by replacing the board, this could be done only at the quinquennial meeting."). Lipton and Rosenblum emphasize how the proposed system will make it easier for institutional investors to nominate candidates for election as directors. *See* Lipton & Rosenblum, *supra* note 4, at 230-31. The authors do not discuss directly the possibility that hostile offers would be made, but they clearly contemplate that possibility. For example, they discuss what the appropriate response would be if "more than one bidder emerged at the quinquennial meeting...." *Id.* at 242.

242. Lipton & Rosenblum, *supra* note 4, at 241.

243. *Id.* at 231.

solicitation materials and from deploying other takeover defenses.[245] If the raider succeeded in having its slate of directors elected, it could (with the approval of those directors) purchase the remainder of the company's stock, presumably at the price announced in its proxy materials.[246]

The $64,000 question, so to speak, is whether restructuring the dynamics of the takeover process in this manner will remedy the underlying managerial problems that concern Mr. Lipton. That question creates a conundrum, though, because Mr. Lipton does not establish, but merely assumes, that hostile takeovers cause those problems.

One approach to resolving this conundrum would be to focus on the benefits Mr. Lipton specifically suggests the proposed restructuring will produce. But another analytic dilemma then arises: Mr. Lipton hypothesizes that benefits will accrue simply because his plan would sharply reduce the frequency of contests for corporate control.[247] Such a reduction seems likely only in one very limited sense — no company could become the target of a hostile bid more than once every five years. On the other hand, Mr. Lipton's plan would reduce dramatically the costs associated with hostile bids,[248] thus making it considerably more likely that any given company will become a target at its quinquennial meetings.

Proponents of the view that hostile takeover bids spur corporate managers to operate more efficiently might, therefore, applaud Mr. Lipton's recommendation,[249] but their support surely is not what Mr. Lipton is seeking.[250] Yet, given the likelihood that Mr. Lipton's scheme would lead to increased numbers of takeover bids, Mr. Lipton's most modest prediction — that "the

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244. *Id.*

245. *Id.* at 241-43.

246. One of many interesting operational questions that might arise is whether a bidder could reduce or withdraw its offer if it discovered, after gaining control of the board, that the target company's financial situation was worse than the bidder anticipated.

247. Mr. Lipton mentions a dramatic reduction in the time and resources corporations will devote to preventing takeovers (Lipton & Rosenblum, *supra* note 4, at 242), removal of takeover-related frictions between managers and institutional stockholders (*id.* at 243), and the likelihood that investors would adopt a longer-term perspective when they purchase a company's stock. *Id.*

248. Both the financial costs and the costs associated with the uncertainty that management will be allowed to employ a poison pill or other defense to "just say no." *See* Yablon, *Poison Pills and Litigation Uncertainty*, 1989 DUKE L.J. 54.

249. In fact, one whose goal was to reduce transaction costs by streamlining and rationalizing the rules governing contests for corporate control might find Mr. Lipton's proposal to be full of intriguing possibilities. So might one interested in facilitating institutional investors' participation in the corporate electoral process. *Cf.* Regulation of Securityholder Communications, Exchange Act Release No. 29,315, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,811 (June 17, 1991) (proposing changes in the proxy rules to facilitate communications between shareholders).

250. *See* Lipton & Rosenblum, *supra* note 4, at 202-15. One possible response by Mr. Lipton would be to alter his proposal to bar all hostile bids and assign exclusive responsibility for initiating changes in control to institutional investors. Such a proposal, though, would raise very difficult implementation problems. In addition, there is reason to be skeptical about whether institutional investors are likely to increase managers' accountability or to promote improved corporate performance. *See* Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); Brickley, Lease & Smith, *Ownership Structure and Voting on Antitakeover Amendments*, 20 J. FIN. ECON. 267 (1988)

quinquennial system would [at least] free the corporation for substantial periods from preoccupation with the threat of a takeover"[251] — becomes his strongest argument.

Whether this argument has merit depends on one's beliefs about what motivates managers' decisionmaking. If managers focus on short-term results to protect against takeovers, as Mr. Lipton suggests, his plan would provide a window of opportunity, after each quinquennial meeting, in which managers could develop and implement long-range strategies without concern about hostile takeovers. But this window of opportunity would not last for five years. Assuming, for the sake of argument, that managers' preoccupation with short-term results is attributable to fear of takeover bids, after two or three years the knowledge that a quinquennial meeting was looming would cause managers to again shorten their planning horizons.[252] Consequently, Mr. Lipton's proposal, at best, could be expected to produce only modest benefits. And if, as seems likely, managers' failures to make long-term investments are due to factors other than hostile takeovers, the changes Mr. Lipton suggests are largely irrelevant.

A third fundamental difficulty with Mr. Lipton's proposal is its inconsistency with his subsidiary goal of promoting cooperation between managers and their principal institutional stockholders.[253] Mr. Lipton argues that restructuring the timing of elections (and takeover bids), requiring five-year plans and reports, and tying managers' incentive compensation to long-term performance all will foster such cooperation. His claims are not persuasive.

It is difficult to believe that major benefits will flow from requiring corporations to publish five-year strategic plans. If those plans are very detailed, managers will give away too much of their strategy and will limit their ability to respond flexibly to changing market conditions. But if, to avoid these dangers, the five-year plans include only generalities, investors will learn little and cooperation will not be enhanced. Mr. Lipton provides no indication of how managers could develop plans that would avoid these dual perils.

Regarding the proposed requirement of five-year reports, similar data — including comparisons of companies within industries — currently are available from a host of financial analysts. Mr. Lipton asserts that the required reports will gain added credibility because they will be accompanied by evaluations prepared by "independent advisors."[254] Here, for sure, he must be jesting. The "independent advisors" will be the same public accountants whose reports institutional investors now hire analysts to decipher, or the same investment bankers whose valuation opinions in connection with tender offers have fueled so many of the tensions that concern Mr. Lipton. That investors suddenly would become willing to credit these advisors' evaluations of how well their corporate clients

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(reporting institutional investors with potential conflicts of interest were more likely to support management positions).

251. Lipton & Rosenblum, *supra* note 4, at 243.

252. Similarly, sophisticated investors probably would begin to purchase stock in companies they viewed as prospective targets, and institutions holding stock in underperforming companies could be expected to signal their interest in selling to potential raiders.

253. *See* Lipton & Rosenblum, *supra* note 4, at 189.

254. *Id.* at 235-36.

have performed seems laughable. Hard learned skepticism surely would remain the order of the day.

Mr. Lipton's proposed requirement that incentive compensation be linked to long-term performance is more difficult to assess, largely because it raises complex implementation issues that Mr. Lipton, renowned for his strategic and practical insights, does not even address, much less resolve. Who would set the rules for what does and does not constitute an acceptable compensation plan? Who would monitor corporations' compliance with those rules? Would courts continue to treat as business judgments directors' decisions relating to compensation matters, or does the proposal that directors also receive incentive compensation suggest that such decisions would be reviewed under the duty of loyalty? Without some indication of the answers Mr. Lipton would provide to these questions, it is not possible to determine whether this seemingly meritorious proposal represents anything more than a public relations gesture.[255]

What remains is Mr. Lipton's suggestion that limiting director elections and potential changes in control to quinquennial meetings will somehow promote more cooperative relationships between directors and institutional investors.[256] Ronald Gilson and Reinier Kraakman point out an internal inconsistency in Mr. Lipton's argument relating to this claim.[257] Mr. Lipton praises the cooperation engendered by the German and Japanese systems of corporate governance, but those systems "provide for continuous monitoring by bank professionals, rather than the episodic, all-or-nothing monitoring [that quinquennial meetings would produce]."[258]

The work of Robert Axelrod,[259] which addresses the problem of how best to promote cooperation in a situation that involves an iterated prisoners' dilemma, suggests a more basic flaw. Professor Axelrod's findings seem to be pertinent to the situation that concerns Mr. Lipton, in that the relationship between corporate managers and shareholders appears to involve an iterated prisoners' dilemma.[260] That is, the two parties (in this case, managers and shareholders) are involved in a long-term relationship in which both of them (and the enterprise as a whole) stand to realize the largest overall gains if the parties cooperate with each other. At the same time, each party has the choice of cooperating with the other or seeking to advance its interests at the expense of the other — conduct Axelrod terms "defection."

To satisfy the conditions of an iterated prisoners' dilemma, future results must be sufficiently important to both parties to induce them to cooperate in the

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255. *See id.* at 238-40 (setting forth proposal and an illustrative plan, but discussing none of these issues). Posing these questions suggests no disagreement with the general concept that managers' incentive compensation should be more heavily linked to long-term performance than short-term results.

256. *Id.* at 225-28.

257. Gilson & Kraakman, *supra* note 235, at 882 & n.68.

258. *Id.* at 883 n.68. Notably, Mr. Lipton does not even mention other aspects of German and Japanese corporate practice, like keeping executives' compensation more in line with that of workers or expecting senior managers to resign in the event of serious mishaps, that American executives surely would not find acceptable.

259. R. AXELROD, THE EVOLUTION OF COOPERATION (1984).

260. For a description of those conditions, see *id.* at 11-12.

present. If the benefits of a one-time defection exceed the present value of the fruits of future cooperation, parties will consistently defect.[261] In public corporations, managers, in particular, may find it attractive to pursue short-term personal benefits even if so doing jeopardizes the long-run profitability of the firm. But Mr. Lipton premises his argument on the belief that managers, more than shareholders, seek to advance their corporation's long-run interests. Moreover, his proposal regarding executive compensation, if implemented effectively, would cause managers to assign even more weight to future results.[262] Thus, the corporate setting, either as it exists or as Mr. Lipton would have it exist, represents one of the class of situations that Professor Axelrod has studied.

In an iterated prisoners' dilemma, Professor Axelrod found, the most successful strategy for any player is to start out cooperating, to cooperate on the next round if the other party cooperates, and to defect on the next round if the other party defects.[263] This strategy, known as "tit-for-tat," does not allow any given player to best another.[264] Nonetheless, it succeeds better than any other strategy in inducing other players to cooperate. As a result, a player who employs tit-for-tat will realize the largest total payoff.[265]

The key to tit-for-tat's success lies in its immediacy, its predictability and its proportionality. The strategy is "nice," in that it begins by cooperating and continues cooperating until the other player defects. Defection, however, is met by an immediate, predictable and proportionate response; the player employing tit-for-tat defects on the next round. Similarly, when the other player again begins to cooperate, tit-for-tat reciprocates by cooperating on the next round. Rivals facing a player who is employing tit-for-tat soon learn that the best way to maximize their total return is to abjure defection and engage in continuous cooperation.

Professor Axelrod emphasizes that to "promote cooperation among members of an organization, relationships should be structured so that there are frequent and durable interactions among specific individuals."[266] Cooperation can be promoted by increasing the importance of the future relative to the pre-

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261. *See id.* at 129 ("*No* form of cooperation is stable when the future is not important enough relative to the present.").

262. To this extent, Mr. Lipton's proposal is consistent with Professor Axelrod's analysis.

263. *See* R. AXELROD, *supra* note 259, at 53-54.

264. In fact, a player who employs tit-for-tat never will best any individual rival, because tit-for-tat never is the first to defect and thus incurs the loss caused by a rival's first defection. *See id.* at 33.

265. Tit-for-tat was the most successful strategy in two "tournaments" played by game theory experts. Its vitality is illustrated by the fact that, in the second tournament, all the entrants knew one player would employ tit-for-tat, yet none were able to design a strategy that produced results superior to those garnered by tit-for-tat. *See id.* at 27-54. Professor Axelrod identified a variety of real-world situations that share the characteristics of an iterated prisoners' dilemma, and demonstrated how strategies identical to tit-for-tat had successfully been employed in those situations. *See id.* at 73-105.

266. *Id.* at 180.

sent,[267] something that Mr. Lipton's proposal regarding executive compensation might accomplish. Cooperation also can be made more likely by breaking issues down into smaller pieces, so as to provide the parties with opportunities for more frequent and more discreet interactions.[268]

If one goal of the corporate governance system is facilitating development of cooperative relationships between managers and shareholders, Professor Axelrod's findings regarding tit-for-tat clearly demand attention. But Professor Axelrod's conclusions conflict sharply with Mr. Lipton's recommendations. Axelrod's work makes clear that to increase cooperation, shareholders and managers should be placed in positions where they can react promptly, predictably and proportionately to defections by the other. Mr. Lipton proposes to limit shareholders to the draconian step of precipitating a change of control once every five years, the antithesis of the strategy Professor Axelrod demonstrates is most likely to succeed.

VII. CONCLUSION

The Delaware courts, building on the efforts of the Second Circuit, have vastly improved the law relating to contests for corporate control. *Unocal*[269] and its progeny represent not a radical break with the past, but a well thought-out evolution of common law doctrines relating to directors' fiduciary obligations in takeover situations. Courts in Delaware and elsewhere no doubt will continue to refine those doctrines as new transactional devices and defensive techniques emerge, as they will when takeovers again become popular.

At the present time, Delaware law represents the state of the art. Delaware's courts have dealt with a large number of takeover cases; the courts of other states have dealt with virtually none. Delaware's approach, as illustrated by the decisions of its courts and federal courts' near universal embrace of Delaware law, has proven to be pragmatic, principled and intellectually coherent.

The recommendations of the ALI's Corporate Governance Project do not improve on Delaware's jurisprudence. They are less comprehensive and less clear than the principles the Delaware decisions articulate. Either the ALI should revise and clarify what it has to say, or courts and state legislatures should ignore this aspect of the ALI Project's recommendations.

Nor does Martin Lipton's proposal warrant approbation. Mr. Lipton is concerned about two important problems, short-sightedness in the corporate community and too much tension in relations between managers and investors. But his plan for reordering the corporate governance system has little relevance to those problems. It may be that unwise takeovers, consummated during the

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267. *Id.* at 129.

268. *See id.* at 132 ("Decomposing the interaction promotes the stability of cooperation by making the gains from cheating on the current move that much less important relative to the gains from potential mutual cooperation on later moves."). In the case of German and Japanese corporations and their institutional shareholders, interactions are frequent and discreet.

269. 493 A.2d 946.

1980's, have imposed substantial costs on the American economy.[270] But Mr. Lipton has not demonstrated that the structure of corporate law had much to do with causing those takeovers to occur, and changes in takeover law, either those he suggests or those embodied in the ALI's recommendations, seem unlikely to eliminate whatever costs they have produced.

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270. *See* Lipton & Rosenblum, *supra* note 4, at 253 (speaking of "financial chaos" and a "speculative frenzy").