PILLS, POLLS AND PROFESSORS: A REPLY TO PROFESSOR GILSON

A WORKING PAPER BY MARTIN LIPTON AND PAUL K. ROWE*

ABSTRACT

In the fifteen years since Unocal Corp. v. Mesa Petroleum Co., *the Delaware courts have developed a comprehensive legal framework for corporate control contests that has led to predictability in corporate governance and furthered the fundamental values of corporation law. Academic criticism of the Delaware model persists, however, reflecting continuing adherence to the efficient market hypothesis and, more broadly, an unexplained academic preference for market transactions over elections as the means of resolving control contests. A recent example of such criticism, exemplified by Professor Gilson's "Unocal Fifteen Years Later (And What We Can Do About It)," advocates reversing the course of Delaware takeover law since 1985, and particularly urges the validation of shareholder bylaws that dismantle a "poison pill."*

*This article defends the key choices of the post-*Unocal *regime of Delaware law. The article first reviews the events that gave birth to the Delaware framework, then summarizes recent attacks on the Delaware model, and finally demonstrates the jurisprudential and practical deficiencies of the criticism. As the article shows, the academic critics propose abandonment of a tested and successful balance notwithstanding the complete absence of evidence indicating that the* Unocal *compromise has harmed corporate governance, damaged shareholder welfare, or impeded economically desirable transactions. The article concludes that there is no reason to depart from the well-reasoned and well-understood* Unocal *rules.*

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Fifteen years ago, the Delaware courts crafted a comprehensive and sensible legal structure governing takeover bids. Today, despite steady acquisition activity and share prices reaching levels that are extremely high by historical standards, the Delaware framework continues to encounter opposition from academic critics. One of those critics, Professor Ronald Gilson, is so hostile to Delaware's approach that he recently advocated the adoption of a set of rules that would represent a wholesale rejection of the framework of Delaware law regarding takeovers and would push Delaware far outside the mainstream of American jurisdictions.[1]

This article advances the view that Professor Gilson, and the other critics[2] of the current Delaware rules, are wrong. In fact, the Delaware approach has proved highly successful by any test—as an internally consistent body of corporate law; as an appropriate regime from a public policy standpoint; and as a driver of shareholder value (putting to one side whether this should be paramount for a corporate law regime). Critics of the Delaware model are not able to identify any substantial way in which the post-1985 case law has distorted Delaware's statutory model; has produced actual unfair or inefficient outcomes; or has damaged overall corporate or shareholder welfare. Instead, the critics' complaint about the current rules reduces to the argument that Delaware takeover law is dysfunctional because it fails to guarantee in every case the results sought by partisans of the efficient market theory.

The critics assume that the efficient market theory is not only correct, but that it is the only appropriate template for building the structures of corporate law. If anything, support for the efficient market theory is much less persuasive today than it was even in 1985, when Delaware rejected it. Since 1985, we have experienced two major events, the 1987 market crash and the NASDAQ bubble of 2000, which contradict the core assumptions of the efficient market theory. Moreover, as will be discussed below, even academic economists have increasingly recognized that the efficient market theory is fundamentally flawed at a conceptual level.

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[1]*See* Ronald J. Gilson, Unocal *Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491 (2001).

[2]While Professor Gilson is among the more prominent critics of the Delaware approach, he is not alone. *See, e.g.*, Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001); John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605 (1997) (suggesting the permissibility of at least certain kinds of bylaws to constrain directors in the context of control contests); Jeffery N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511 (1997).

The best way to understand the current attacks on Delaware corporate law is to review the historical developments that in 1985 gave birth to the current legal framework. This article first describes how the unprecedented takeover activity of the early 1980s required Delaware to devise a new model of corporate governance. This article will then summarize the most recent attacks on the Delaware model, and demonstrate why such attacks are misguided. The resonating theme is the underlying struggle between two points of view that have hardly changed within the past twenty years. On the one side are the partisans of the efficient market theory who believe there should be no, or minimal, impediments from boards or the courts to takeovers, and that corporate law should be judged against the single standard of the "free market" in corporate control. On the other side are a variety of other participants in the debate who do not accept the efficient market theory as the only, or the best, guide for corporate law decision making. In particular, they dispute whether legal rule-making based on the efficient market theory in fact leads to shareholder value maximization, and whether short-term shareholder value maximization is the only value the legal system should respect.

The flashpoint of the current debate is the bylaw permitting shareholders to unilaterally dismantle a "poison pill." The Delaware courts have not encountered a case that requires them to rule on such a bylaw, but the efficient market theory partisans view the bylaw as their latest and best hope to effect the repeal of *Unocal Corp. v. Mesa Petroleum Co.*,[3] *Unitrin, Inc. v. American General Corp.*,[4] *Moran v. Household International, Inc.*,[5] *Paramount Communications, Inc. v. Time Inc.*,[6] *Quickturn Design Systems, Inc. v. Shapiro*,[7] and the rest of the post-1985 Delaware legal framework. Should Delaware affirm the validity of these bylaw amendments, the practical effect would be to drastically upset the balanced approach taken since 1985. Consequently, corporations would be unable to rely on the protection that has been afforded by the poison pill since 1985. Yet directorial responses to takeover bids would remain reviewable under a standard much less favorable to takeover defense than what prevailed before 1985. Professor Gilson is at least candid in admitting that the validation of the pill-repeal bylaw would gut *Household* and *Unocal*.[8] If

[3]493 A.2d 946 (Del. 1985).

[4]651 A.2d 1361 (Del. 1995).

[5]500 A.2d 1346 (Del. 1985).

[6]571 A.2d 1140 (Del. 1990).

[7]721 A.2d 1281 (Del. 1998).

[8]Gilson, *supra* note 1, at 512 ("Shareholder initiated bylaws provide an imperfect, but realistic, way to turn back the clock.").

stockholders can tell the board that directors' fiduciary duties do not allow for adoption of a pill, then there are no teachings left of *Unocal*, *Household*, and *Quickturn* that the board's statutory duties may require it to oppose some takeover proposals and that the pill, appropriately used, is an acceptable way to do so.

I. THE HISTORICAL CONTEXT OF THE CURRENT DEBATE

Prior to 1968, there was little statutory or common law regulation of takeover activity. The chief public policy response to pre-1960's merger activity was the edifice of antitrust jurisprudence. By contrast, the law of fiduciary duties relating to mergers was undeveloped. As late as 1972, virtually the only modern appellate opinion that spoke to the permissibility of resistance to takeovers was *Herald Co. v. Seawell*,[9] a decision that turned on considerations unique to the newspaper industry.

With the increase in conglomeration and the ability of firms with high price-earnings multiples to launch "Chinese paper" bids for blue-chip companies, the late 1960s saw Congressional enactment of the Williams Act[10] (1968) and the first state takeover statutes (beginning with Virginia in 1968[11]). Corporate practitioners put in place "shark repellent" charter amendments and bylaws that were intended to increase the ability of a board to fend off undesirable takeovers. Hostile bids reached maturity in the 1970s, the watershed event being International Nickel of Canada's (Inco) bid for ESB, an unprecedented case of one blue-chip industrial making a hostile bid for another.[12] The willingness of Morgan Stanley,

[9]472 F.2d 1081 (10th Cir. 1972). In *Herald Co.*, the court expressly held that in addition to their duty to stockholders, directors—at least directors of certain kinds of corporations such as newspapers—have an obligation to employees and the public. *Id.* at 1091. The directors in that case were justified in averting a takeover which they believed "would have an adverse impact on the character and quality" of the newspaper, and would lead to "poor relations with employees." *Id.* at 1092.

[10]The Williams Act, in the form of various amendments to the Securities Exchange Act of 1934, was enacted on July 29, 1968. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454.

[11]VA. CODE ANN. §§ 13.1-528 to 13.1-541 (1973) (repealed 1989). Implementation of the Williams Act in 1968 preempted Virginia's four-month-old Take-Over Bid Disclosure Act. Virginia's short-lived disclosure act was the first statute regulating tender offers in the country. It required a person acquiring a controlling interest in a target corporation to disclose certain information to shareholders. The Act also attempted to regulate other aspects of takeover bids, including a bid's duration.

[12]*See Hostility Breeds Contempt in Takeovers, 1974*, WALL ST. J., Oct. 25, 1989. Inco offered $28 a share for ESB, a Philadelphia battery maker. "ESB said it was given only a three-hour advance warning on a 'take it or leave it' basis from Inco." *Id.* ESB spurned Inco and within five days ESB found a "white knight" (United Aircraft), which offered $34 a share. "ESB

then the pre-eminent investment banker to America's corporate establishment, to serve as advisor to the bidder was confirmation that hostile takeovers were no longer the province of the upstart or outsider.

But the full impact of hostile bids truly set in when they were married to novel financing techniques, such as junk bonds, bridge loans and highly confident letters introduced by Drexel Burnham Lambert. Bids migrated in form from the all-cash, all-shares proposals typical in the 1970s to the favored model of the corporate raider of the early 1980s, the two-tiered, front-end-loaded model that was largely financed by the target's own assets (bootstrap). The goal of such bids was not to improve the management of the target's assets or to reap synergies from an existing rival, but to "bust up" the corporation and sell the pieces for a quick profit. The bidders were often seeking quick returns, not improved enterprises.

Not surprisingly, directors resisted such tactics. The bidders litigated, and the courts, in decision after decision, applied pre-existing business judgment rule principles to takeover defenses. Key decisions came from *Panter v. Marshall Field & Co.*[13] in the Seventh Circuit, *Johnson v. Trueblood*[14] in the Third Circuit, and *Crouse-Hinds Co. v. InterNorth, Inc.*[15] in the Second Circuit. In Delaware, prior to *Unocal*, traditional business judgment rule protection was accorded to directors who rejected a takeover proposal.[16]

The pre-*Unocal* rule for takeovers, that normal, "plain vanilla" business judgment rule principles applied to board conduct in response to unsolicited bids, recognized that responding to an unsolicited bid required the exercise of fundamental business judgment and that a board's decision to resist a premium-to-market takeover proposal should not be evaluated by a more intrusive legal standard simply because it might result in reduced

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directors warmly accepted, but a whirlwind bidding match ensued." *Id.* Within a few days, Inco raised its bid to $36, and then to $38, which United Aircraft matched. But later the same day, Inco raised its offer to $41, and United Aircraft withdrew. Eleven days after Inco's initial offer at $28, ESB accepted Inco's offer, and the "brief battle" was over. *Id.* Nevertheless, the Inco/ESB battle is often referred to as the transaction that made hostile takeovers respectable.

[13] 646 F.2d 271, 299 (7th Cir. 1981) (observing that to straitjacket directors faced with a takeover offer "is in direct conflict with the duty of directors to evaluate proposed business combinations on their merits and oppose those detrimental to the well-being of the corporation even if that is at the expense of the short term interests of individual shareholders").

[14] 629 F.2d 287 (3d Cir. 1980) (finding defendant directors protected by the business judgment rule).

[15] 634 F.2d 690 (2d Cir. 1980).

[16] *See, e.g.*, Pogostin v. Rice, 480 A.2d 619, 627 (Del. 1984) (holding that acceptance of an entrenchment argument based solely on an allegation that the board voted to reject a tender offer "would condemn any board, which successfully avoided a takeover, regardless of whether that board properly determined that it was acting in the best interests of the shareholders").

short-term (or even long-term) returns to shareholders.[17] Every time a board makes a major business decision, whether it is to build an Edsel, to enter into a new line of business, or to refuse a settlement offer in a tort suit, it is possible that its decision will prove financially disastrous and sharply cut returns to shareholders. The proxy contest mechanism was and still is considered sufficient to permit shareholders to "punish" managers who make such mistakes.

Notwithstanding these well-established core principles, the direction of takeover law appeared very much up for grabs at the turn of the 1980s. While law and economics academics were applauding the increase in takeover activity, practicing lawyers who were heavily involved in the activity, and had to advise targets and raiders on a day-to-day basis and then vindicate that advice in court, found the undeveloped state of the law most unsatisfactory. In 1979, Martin Lipton, who was involved in many of the takeover battles of the 1970s, wrote a seminal article arguing that the directors of a target company should be governed by the business judgment rule and that in exercising their judgment they could take into account the interests of employees, communities and other constituents, as well as the long-term interests of the shareholders.[18] This position was quickly rejected by academic adherents of the efficient market theory who argued for the so-called "Rule of Passivity," relegating directors to passive observers proscribed from any action other than advice to the shareholder. A classic series of articles ensued,[19] with the courts resolving the debate in

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[17]The applicability of the business judgment rule to takeover defense follows directly from the Delaware statute. "A board's response to an offer to merge is traditionally tested by the business judgment rule since a statutory prerequisite [DEL. CODE ANN. tit. 8, § 251(b) (2000)] to a merger transaction is approval by the Board before any stockholder action." Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1375 n.16 (Del. 1995).

[18]Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 130 (1979).

[19]*See, e.g.*, Leo Herzel et al., *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107 (1980); Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733, 1750 (1981) (arguing that decisions as to tender offers do not involve management of the corporation's affairs in any meaningful sense and can be made by the shareholders); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1191, 1198, 1201 (1981) (defending their proposal of director passivity in response to tender offers by distinguishing between a board's role in tender offers and its role in other situations); Martin Lipton, *Takeover Bids in the Target's Boardroom; A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231 (1980); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 878-79 (1981) (arguing that in the face of a tender offer, management of the target company should take no action other than to: (1) disclose information bearing on the value or attractiveness of the offer, and (2) seek out alternative transactions, which it believes

favor of the business judgment rule.[20]

This exchange of articles reflected a fierce public policy debate. On the one hand, the new breed of hostile bids was wreaking havoc with expectations of managers, employees and communities. On the other hand, it was enriching a new class of raiders on Wall Street, the bankers who advised, financed, or arbitraged takeovers. The pro-takeover forces were theoretically supported by a group of economists from the finance theory branch of economics who adhered to the efficient market theory and seemed to support the proposition that shareholder wealth could be maximized by outlawing most forms of takeover defenses. Starting from the premise that share prices accurately reflect the intrinsic value of a corporation, efficient market theory partisans contended that board reluctance to accept a premium price necessarily reflects the instinct of self-preservation rather than conviction that the tender price is inadequate. According to this view, defenses served only to entrench incumbents and necessarily harmed shareholders.

The opponents of the efficient market theory pointed out that corporations were not chartered by the states solely to maximize shareholders' short-term gains,[21] and that large corporations could not function in an environment where they were "for sale" whenever their market cap dipped below the break-up value of their assets.[22] Tender offers

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may be more favorable to target shareholders); Martin Lipton, *Takeover Bids in the Target's Boardroom*, 36 BUS. LAW. 1017 (1981); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1054 (1982) (arguing that although incumbent management should be barred from actions that obstruct any tender offer, management should diligently seek a higher offer); Martin Lipton & Andrew R. Brownstein, *Takeover Responses and Directors' Responsibilities: An Update*, ABA National Institute on the Dynamics of Corporate Control (Dec. 1983) (noting that boards must consider the nature of a takeover bid and its effect on the corporate enterprise, including the adequacy of the price, the nature and timing of the offer, the impact on constituencies other than shareholders, the risk of nonconsummation, and the quality of the securities being offered in the exchange); *see also* Martin Lipton, *Boards Must Resist*, N.Y. TIMES, Aug. 9, 1981, at 2F, col. 5; Martin Lipton, *Takeover Abuses Mortgage the Future*, WALL ST. J., Apr. 5, 1985, at 16.

[20]*See* Panter v. Marshall Field, 646 F.2d 271 (7th Cir. 1981); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Kahn v. MSB Bancorp, Inc., No. 14,712-NC, 1998 Del. Ch. LEXIS 112 (Del. Ch. July 16, 1998), *reprinted in* 24 DEL. J. CORP. L. 266 (1999), *aff'd*, 734 A.2d 158 (Del. 1999).

[21]For a very different view of the corporation, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

[22]Corporation law is designed to protect the "*long-term value of capital* committed indefinitely to the firm," see William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894, 896-97 (1997). It does not share the short-term horizon of takeover arbitrageurs. *See also* Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 189 (1991).

are not the functional equivalents of free votes because the decision not to tender carries with it economic risks and detriments. For instance, in not knowing whether the mass of other shareholders will tender or not, the individual holder faces the classic "prisoners' dilemma" and is effectively stampeded into tendering. The opponents also observed that many hostile bids were opportunistic attempts to buy assets *on the cheap*, and that there was no empirical evidence that such takeovers were always (or ever) good for the economy.[23] Moreover, the opponents responded, the view that directors were only capable of acting in their self-interest was unsupported by empirical evidence and inconsistent with the assumptions underlying the structure of American corporate law.[24]

State legislatures around the country resolved this debate squarely in favor of directorial discretion. Between 1968 and 1982, laws designed to slow or halt the wave of opportunistic takeover activity were enacted in thirty-seven states.[25] Thus, by the early 1980s, both the legislatures and the courts had emphatically rejected the efficient market theory/raider position

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[23]*See, e.g.*, Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 23 (1987) ("The advent of the highly leveraged takeover, and the defensive responses to it, have forced companies to focus on short-term profitability rather than on capital investment or long-term planning, research, and development.") (citations omitted); JONATHAN P. CHARKHAM, KEEPING GOOD COMPANY: A STUDY OF CORPORATE GOVERNANCE IN FIVE COUNTRIES 219, 229 (1994) (arguing that putting great emphasis on shareholders' immediate values may result in competitive disadvantage compared to other nations' systems that take a longer-term view); John Pound, *The Promise of the Governed Corporation*, HARV. BUS. REV., Mar.-Apr. 1995, at 91, 91 ("Many takeover bids themselves represent flawed decisions by the acquirer"); Edson Spencer, *The U.S. Should Stop Playing Poker with Its Future*, BUS. WK., Nov. 17, 1986, at 20, 20 (arguing that Wall Street has adopted the view that "the higher the stock price, the better management has done its job," leading managers "to put short-term earnings growth before such interests as market development, product quality, research and development, and customer and employee satisfaction"); Richard L. Stern & Edward F. Cone, *Scarlett O'Hara Comes to Wall Street*, FORBES, Sept. 21, 1987, at 37, 37-38 (reporting competition to provide financing for leveraged acquisitions and suggesting that valuations were driven up to unsupportable levels); Harold M. Williams, *It's Time for a Takeover Moratorium*, FORTUNE, July 22, 1985, at 133, 136 (stating that takeover activity has resulted in a "loss in management effectiveness [that] works against corporate and national productivity, the wages of employees, and returns to stockholders. It undermines our economy and our society"). *See also* Allen D. Boyer, *Activist Shareholders, Corporate Directors, and Institutional Investment: Some Lessons from the Robber Barons*, 50 WASH. & LEE L. REV. 977, 1004-05 (1993) (explaining that as leveraged buyouts increased and junk bonds became popular, a new group of investors entered and expanded the market for low-grade debt).

[24]*See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2000) (providing that the business and affairs of every Delaware corporation shall be managed by a board of directors). This is an eminently sensible state of affairs; among other advantages, directors have much better (non-public) information and far lower costs of communication than do shareholders.

[25]INVESTOR RESPONSIBILITY RESEARCH CTR. INC., STATE TAKEOVER LAWS, app. B-5 (1998).

that directors should be sterilized in the face of takeover bids.[26] This changed in 1982 when, by a razor-thin margin, the United States Supreme Court invalidated the "first generation" of takeover statutes in *Edgar v. MITE Corp.*[27] Consequently, there was nothing to delay the consummation of a tender offer beyond the Williams Act's twenty business days. Increasingly, boards turned to creative attempts to release short-term value by selling pieces of the business or turning to a white knight. However, these alternative transactions were often difficult to achieve on the truncated time-line of the Williams Act minimum.

The *MITE Corp.* decision coincided with the decision of most institutional investors that they would not vote for charter amendments designed to deter or regulate hostile takeovers, and also with the federal courts picking up on an earlier decision by Judge Henry Friendly, in which he treated with great skepticism suits brought by targets raising antitrust, disclosure, and similar claims to enjoin hostile bids.[28] Thus, the playing field was heavily tipped in favor of the corporate raiders and peddlers of junk bonds. In September 1982, Mr. Lipton published a memorandum describing the "Warrant Dividend Plan."[29] The "warrant" was a security that could be issued by the board of directors of a target company that would have the effect of increasing the time available to the board to react to an unsolicited bid and allow the board to maintain control over the process of responding to the bid. In various forms it was used successfully by targets of hostile bids in 1982 and 1983 to gain time and maximize shareholder value. In 1983, Mr. Lipton's plan was christened with the unfortunate name "poison pill" by an investment banker who had nothing

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[26]*See supra* note 20.

[27]457 U.S. 624, 632-34 (1982) (plurality opinion concluding that the Williams Act struck a careful balance between the interests of offerors and target companies, and that any state statute that "upset" this balance was pre-empted).

[28]*See* Missouri Portland Cement Co. v. Cargill, Inc., 498 F.2d 851 (2d Cir. 1974), *cert. denied*, 419 U.S. 883 (1974); Scientific Computers, Inc. v. Edudata Corp., 599 F. Supp. 1092, 1098 (D. Minn. 1984); American Gen. Corp. v. NLT Corp., Fed. Sec. L. Rep. (CCH) ¶ 98,808, at 94,142 (S.D. Tex. July 1, 1982) ("'district judges should take arguments of serious harm to a corporation due to jitters in executive suites with a fair amount of salt'") (quoting *Cargill*, 498 F.2d at 872); Raybestos-Manhattan Inc. v. Hi-Shear Indus., 503 F. Supp. 1122, 1134 (E.D.N.Y. 1980) (stating that "[t]he Second Circuit has warned district courts to look skeptically on Clayton Act claims raised by target management who become vigilant enforcers of the antitrust laws only when a tender offer threatens their control").

[29]Memorandum from Martin Lipton on Warrant Dividend Plan (Sept. 15, 1982) (on file with author).

to do with its creation.[30]

In spite of the name, the pill's arrival was remarkably timely. As the tide of junk-bond-financed bootstrap bids, sometimes linked to two-tier, front-end-loaded tender offers, rose in the mid-1980s, there was increasing recognition that something was needed to redress the balance between the corporate raider and the board of the target. The pill filled precisely that need. The introduction of the poison pill between 1983 and 1984 was viewed by efficient market theory proponents as a radical innovation, and the attacks on the pill's validity were unrelenting.[31]

The increasing use of the pill in 1984-1985 set the stage for a decisive confrontation between the forces advocating a free hand for corporate raiders and those supporting the business judgment rule approach. The question remained, who would act as the decision maker? At the federal level, Congress had shown no interest in adopting a statutory framework for regulating takeovers beyond the Williams Act and by 1983, the federal impulse for further regulation even at the administrative level (Securities Exchange Commission) had petered out. The United States Supreme Court in *Santa Fe Industries, Inc. v. Green*[32] had extinguished the ability of federal judges to federalize substantive takeover law through the securities laws. On the other hand, the Court's opinion in *MITE Corp.* had blunted the ability of state legislatures to impose their own statutory regulation in the area.[33] Meanwhile, increasing corporate reliance on

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[30] When asked by a *Wall Street Journal* reporter what a security issued by Lenox, Inc. on the advice of Mr. Lipton was called, the investment banker responded flippantly "a poison pill." Frank Allen & Steve Swartz, *Lenox Rebuffs Brown-Forman, Adopts Defense*, WALL ST. J., June 16, 1983, at 2.

[31] *See, e.g.*, Robert A. Helman & James J. Junewicz, *A Fresh Look at Poison Pills*, 42 BUS. LAW. 771 (1987) (suggesting that the poison pill may be invalid or financially inconsequential); Jonathan Shub, Comment, *Shareholder Rights Plans—Do They Render Shareholders Defenseless Against Their Own Management?*, 12 DEL. J. CORP. L. 991 (1987) (arguing that a board's unilateral adoption of a poison pill usurps the right of shareholders to decide whether to sell their stock to a purchaser); Ralph C. Ferrara & William J. Phillips, *Opposition to 'Poison Pill' is Mounting*, LEGAL TIMES, Oct. 15, 1984, at 13; Kim Masters, *'Poison Pill' Takeover Defense Stirs Controversy, Uncertainty*, LEGAL TIMES, Aug. 29, 1983, at 1; Gelvin Stevenson, *A Poison Pill That's Causing a Rash of Lawsuits*, BUS. WK., Apr. 1, 1985, at 54.

[32] 430 U.S. 462, 479 (1977) ("Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.").

[33] *See supra* note 27 and accompanying text. The states were, however, active in reversing several federal court rulings, which held that the pill was invalid under state corporate statutes. *Every* court ruling invalidating pills was legislatively overturned. *See, e.g.*, N.J. STAT. ANN. § 14A:7-7 (West Supp. 2001) (legislatively overturning an August 1986 New York federal

defensive tactics and the increasingly shrill objections of their opponents, created a pressing practical need for dependable legal ground rules. The Delaware courts remained as the only institutional actor with the power and will to fashion a comprehensive resolution.

By 1985 Delaware was ready to act. In that year, the Delaware Supreme Court decided four cases,[34] which have created the framework that has governed takeover law ever since.

The key choices Delaware made in 1985 were the following:

In *Van Gorkom*, Delaware decisively rejected the efficient market theory. It not only permitted, but required directors to make takeover-related decisions based on an informed view of the "intrinsic" value of the corporation—not the value assigned by the stock market.[35]

In *Unocal*, Delaware accepted the utility and appropriateness of "takeover defenses." Nevertheless, the court announced that henceforth, such defenses would be reviewed under a tougher and objective "reasonable in relation to the threat posed" test, rather than the pre-existing deferential and subjective "business judgment rule."[36]

In *Revlon*, Delaware required directors to maximize short-term value once they decided to sell a company for cash.[37] Conversely, Delaware decided that it would not require directors to maximize short-term value outside this particularly narrow situation. Delaware companies are not required to be for sale twenty-four hours a day and seven days a week. Directors could agree to friendly stock mergers without putting the firm "in play" or having to "auction" the company.[38]

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district court case applying New Jersey corporate law, which invalidated NL Industries' flip-in poison pill); N.Y. BUS. CORP. LAW § 505(a)(2) (West Supp. 2001) (legislatively overturning a July 1988 New York State Supreme Court decision invalidating Irving Bank's flip-in poison pill). *See also* Amalgamated Sugar Co. v. NL Indus., Inc., 644 F. Supp. 1229 (S.D.N.Y. 1986) (applying New Jersey corporation law to enjoin implementation of flip-in plan); Bank of N.Y. Co. v. Irving Bank Corp., 536 N.Y.S. 2d 923 (N.Y. Sup. Ct. 1988), *aff'd without opinion*, 533 N.Y.S.2d 411 (Table) (N.Y. App. Div. 1988) (invalidating flip-in provisions as discriminatory against shareholders of the same class).

[34]Revlon Inc. v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173 (Del. 1986); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[35]*Van Gorkom*, 488 A.2d at 875-76.

[36]*Unocal*, 493 A.2d at 954-55, 957.

[37]*Revlon*, 506 A.2d at 182.

[38]MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1248 (Del. Ch. 1985). Although this implication of *Revlon* was reasonably clear from the opinion, the efficient market partisans refused to acknowledge it as Delaware doctrine until the Delaware Supreme Court had the opportunity to make it an express holding four years later in *Time Warner*. *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 n.12 (Del. 1990) (A corporate board of directors "is not under any *per se* duty to maximize shareholder value in the

In *Household*, Delaware permitted boards to adopt a structural defense—the poison pill.[39] *Household* recognized that the pill gave boards the power to "just say no" until such time as the shareholders replaced the incumbent directors, if they so wished. This decision further established that judicial review of a board's use of the poison pill would be subject to the objective *Unocal* standard,[40] rather than the more deferential business judgment rule.[41]

Clearly, these four crucial decisions represented a set of compromises. Delaware did not accept the pleas of corporate constituencies for continued application of the deferential business judgment rule to takeover defense. Neither did it endorse the demands of corporate raiders and academics, who sought to outlaw takeover defenses. Instead, Delaware chose a middle ground. Takeover defenses were permitted, but they were to be judged in common law fashion under a fact-intensive, case-by-case analysis, in which the directors would effectively bear the burden of showing not merely their good faith, but also the "reasonableness" of their chosen response.

When put to the practical test during the half-decade of intense hostile takeover activity that ensued, the new Delaware paradigm worked well. Contrary to the fears of both sides, *Unocal* and its siblings did not usher in a period in which every takeover defense was either condemned or rubber-stamped. A review of some of the major cases of that period demonstrates the suppleness of the standard and the discriminating manner in which it was applied.[42]

Of the quartet of 1985 decisions, the one that proved to have the greatest practical impact was undoubtedly *Household*—the pill changed everything.[43] Instead of twenty business days, boards thereafter frequently

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short-term, even in the context of a takeover." Moreover, the court stated that "it is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value . . . .").

[39]*See Household*, 500 A.2d at 1357.

[40]*Id.*

[41]*Id.*

[42]*See, e.g.*, Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227 (Del. Ch. 1988) (enjoining restructuring adopted in response to unsolicited bid); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987) (upholding special dividend issued to facilitate a "street sweep" to defeat a two-tier offer); AC Acquisitions v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986) (enjoining recapitalization adopted in response to hostile bid).

[43]*See* Stevenson, *supra* note 31, at 58.

> "This is probably the single most important corporate law case to come before the courts in years." . . . Legal challenges [to the pill] have proliferated [throughout the United States]. . . . But the [*Household*] case in Delaware is the crucial one. Because so many companies are incorporated there, and because

had months to consider, respond to, and craft alternatives to unsolicited bids. Contrary to the arguments of the plaintiffs in *Household*,[44] the pill actually revived the importance of proxy contests as a means of determining a corporation's future. Indeed, the Delaware courts rarely receive the credit they deserve for being right about the factual and empirical arguments made by the pill's opponents in *Household*. Professors and experts were paraded in the court of chancery to testify that validation of the pill in Delaware would suppress proxy contests.[45] However, both the court of chancery and the Delaware Supreme Court refused to be persuaded by these "experts." With hindsight we know that the pill simply did not do what its opponents said it would do. As the court of chancery correctly predicted, the pill did not spell the doom of proxy contests.[46]

Despite Delaware's rejection of the efficient market theory and the arguments advanced by academics, the new 1985 rules were met with wide acceptance. Corporate raiders did not abandon the market for corporate control.[47] Corporations did not seek to reincorporate out of Delaware in order to avoid the new regime. In fact, litigators increasingly chose the Delaware state forum over federal and non-Delaware state courts when there was a need for adjudication. Interestingly, the pill even became a standard feature in initial public offering charters, a context in which management entrenchment is virtually absent.[48]

> the court is widely respected, "its decision will set the tone for rulings in other state and federal courts" . . . .

Id. (quoting Irving S. Shapiro, former chairman and chief executive officer of DuPont Co. and former chairman of the Business Roundtable).

[44]Plaintiffs in *Household* argued that the pill's restriction upon individuals or groups from first acquiring 20% of shares before waging a proxy contest would reduce the potency of proxy contests. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1355 (Del. 1985). Even the SEC filed an *amicus curiae* brief in support of the appellants. *See id.* at 1354.

[45]*See* Moran v. Household Int'l, Inc., 490 A.2d 1059, 1079 (Del. Ch. 1985).

[46]*See id.* at 1080. "On the evidence presented it is highly conjectural to assume that a particular effort to assert shareholder views in the election of directors or revisions of corporate policy will be frustrated by the proxy feature of the Plan." *Id.*

[47]As the Delaware Supreme Court noted in 1989:

> [T]he spate of takeover litigation . . . readily demonstrates that such "poison pills" do not prevent rival bidders from expressing their interest in acquiring a corporation . . . . Because potential bidders know that a pill may not be used to entrench management or to unfairly favor one bidder over another, they have no reason to refrain from bidding if they believe that they can make a profitable offer for control of the corporation.

Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1287 (Del. 1989).

[48]*See* Robert Daines, *Does Delaware Law Improve Firm Value?*, NYU Center for Law and Business Wkg. Paper No. CLB-99-011, at 27, *available at* http://papers.ssrn.com/paper.taf?abstract_id=195109 (1999).

But the 1985 Delaware rules were controversial and perceived as insufficiently sensitive to the realities of the corporate life to provoke a legislative reaction in other states. It is significant that, despite Delaware's primacy as a corporate domicile, and despite academic criticism of Delaware as being too protective of management,[49] the Delaware regime has not been broadly embraced by the other states. Indeed, a number of states enacted legislation that to a greater or lesser extent, rejected the Delaware compromise as being too favorable to corporate raiders and hostile bids,[50] too suspicious of the motives of directors,[51] and too unresponsive to the legitimate interests of non-shareholder constituencies such as employees and communities. No jurisdiction in the United States went further than Delaware to adopt statutes or create case law that tightly restricts takeover defenses. Nor has any jurisdiction adopted a framework for takeover law based on the efficient market theory or gone farther than Delaware in that direction.

If anything, after 1985 there was a growing realization that the extreme simplicity of the world view of the efficient market theory partisans was neither an accurate description of reality nor a desirable goal.[52] In 1987, the United States Supreme Court, which in 1982 rejected states' efforts to regulate takeovers through so-called "first generation" statutes, switched sides and endorsed "second generation" statutes in *CTS*

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[49]A growing body of academics view Delaware corporation law as, on balance, highly successful. *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (Christopher C. DeMuth & Jonathan R. Macey, series eds., AEI Press, 1993); Daines, *supra* note 48; Marcel Kahan, Paramount *or Paradox: Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583 (1994).

[50]*See, e.g.*, IND. CODE ANN. §§ 23-1-35-1(f) (West 1990). Title 23 governs standards of conduct for directors and rejects the *Unocal* compromise as being "inconsistent with the proper application of the business judgment rule under this article. Therefore, the general assembly intends . . . to protect both directors and the validity of corporate action taken by them in the good faith exercise of their business judgment after reasonable investigation." *Id.* When the Supreme Court upheld Indiana's control share acquisition statute in *CTS Corp. v. Dynamics*, the Court ushered in a new era in state activism regarding takeovers. *See* CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987). *See also* 805 ILL. COMP. STAT. 5/8.85 (1993); N.J. STAT. ANN. § 14A:7-7 (West Supp. 2001); N.Y. BUS. CORP. LAW § 717(b) (McKinney 2001); OHIO REV. CODE ANN. § 1701.59(E) (Anderson 2001).

[51]*Unocal* assumed that the "perks" of outside directorship are substantial enough to cause independent directors to be less trustworthy in making takeover-related decisions than garden-variety business decisions. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 958 (Del. 1985). We are aware of no research or evidence on this point, and it is certainly not self-evident.

[52]Efficient market theorists believe that there is no place for any interference with the presumed "right" of shareholders to sell the company at any time to a bidder opposed by the board, and that directors should therefore be "passive instrumentalities."

Corp.[53] The 1987 market "break," and the 1990 collapse of Drexel Burnham Lambert, the most prominent financier of hostile bids in the 1980s, further damaged the prestige and persuasiveness of the efficient market theory.[54]

In 1988, Delaware adopted its own "second generation" statute.[55] This enactment is Delaware's only major legislative response to the takeover issue, and it clearly represents a further rejection of the efficient market theory. Under section 203, directors have the statutory power to effectively block potential transfers of control to substantial shareholders by refusing to approve a transaction. While this power is not absolute, it can be overridden only by a very high "supermajority" of eighty-five percent of the shareholders. Section 203 is, in effect, a statutory pill that can be neutered by a tender that attracts eighty-five percent of the shares. Like the 1985 cases, section 203 is another Delaware compromise, but clearly one that recognizes that directors have a major role in determining the corporation's fate in a takeover situation.

Events of the 1990s have demonstrated the wisdom of the Delaware compromise. The coercive, highly leveraged, and often destructive attributes of the 1980s takeover market have faded from view. Secure in their ability to resist hostile bids, directors have used this authority to enhance shareholder value. Directors can use this same power to resist a transaction they reasonably believe to be insufficient or unduly speculative. This is a power of no mean significance. It is protective of the interests of shareholders and, indeed, every corporate constituent. Confirming the position first advanced by Martin Lipton in 1979,[56] the American Law

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[53]CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987) (holding that the Indiana control share acquisition statute was a legitimate exercise of state authority, and that it did not conflict with federal tender offer regulation).

[54]It is perhaps outside the terms of academic argument, but nonetheless suggestive, to recall the subsequent careers of the bidders whose takeover proposals were opposed by boards in some of the high-profile cases of the 1980s. For example, the board of Macmillan, Inc. was harshly criticized by the Delaware courts for opposing Robert Maxwell's 1988 bid for the company. But in light of the revelations of dishonesty, corporate looting and other wrongdoing that followed Maxwell's presumed suicide in 1991, does the Macmillan board now look quite so unreasonable in preferring a 20¢ per share lower bid from Maxwell's rival Henry Kravis? While the Maxwell and Macmillan transaction is perhaps the most thought-provoking example, is there anything in the subsequent business careers of such icons of the 1980s as T. Boone Pickens, Carl Icahn, Paul Bilzerian, and Robert Campeau to suggest that corporate law should have been redesigned to put these people in charge of important enterprises and large pools of assets?

[55]DEL. CODE ANN. tit. 8, § 203 (2000). This statute governs business combinations with interested shareholders.

[56]Lipton, *supra* note 18, at 130.

Institute[57] endorsed Delaware's takeover jurisprudence as a model for the nation:

> § 6.02 Action of Directors That Has the Foreseeable Effect of Blocking Unsolicited Tender Offers:
>
> (a) The board of directors may take an action that has the foreseeable effect of blocking an unsolicited tender offer [§ 1.39], if the action is a reasonable response to the offer.
>
> (b) In considering whether its action is a reasonable response to the offer:
>
> (1) The board may take into account all factors relevant to the best interests of the corporation and shareholders, including, among other things, questions of legality and whether the offer, if successful, would threaten the corporation's essential economic prospects; and
>
> (2) The board may, in addition to the analysis under § 6.02(b)(1), have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders.
>
> (c) A person who challenges an action of the board on the ground that it fails to satisfy the standards of Subsection (a) has the burden of proof that the board's action is an unreasonable response to the offer.
>
> (d) An action that does not meet the standards of Subsection (a) may be enjoined or set aside, but directors who authorize such an action are not subject to liability for damages if their conduct meets the standard of the business judgment rule [§ 4.01(c)].[58]

In the same vein, it should be noted that the two major structural innovations Delaware adopted since 1985, the poison pill and section 203, have not given rise to significant case law. While Delaware has announced the *Unocal* standard under which poison pill decisions are reviewed, there

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[57] "The Reporters believe that the result[] in . . . the [*Time Warner*] case [is] consistent with the principles stated in § 6.02." THE AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE, REPORTER'S NOTE, pt. VI, § 6.02, at 430 (1994). It is interesting to note that Professor Gilson was a co-reporter of Part VI of the ALI Principles of Corporate Governance.

[58] *Id.* at 405.

are currently no Delaware state court decisions addressing instances in which directors stood behind the *Household* pill or their section 203 powers.[59] After fifteen years, the absence of such case law strongly suggests that both the pill and section 203 are being responsibly utilized by Delaware boards and that the system within which they operate is healthy. After fifteen years, we can say that the pill has been used, not abused.

II. GILSON'S ATTACK ON DELAWARE

Professor Gilson's recent article is a good example of the tenor of the arguments advanced today by the opponents of the Delaware compromise. Professor Gilson starts with the observation that since *Unocal,* Delaware law has failed to develop in a manner that would be considered optimal by adherents of the efficient market theory. Specifically, he believes that *Unocal* (particularly since *Unitrin*'s reformulation of the doctrine) gives virtually unfettered discretion to boards to oppose unsolicited takeover proposals. Furthermore, he assumes that, despite the clear language in *Household* to the contrary,[60] and the clear precedent to the contrary in cases such as *Moore Corp. Ltd. v. Wallace Computer Services, Inc.*,[61] directors will have to expend little effort to persuade courts that their decision to "stand behind" the poison pill should be upheld.[62] From the proposition that current Delaware law empowers boards and de-fangs raiders, he proceeds to the conclusion (which follows as a matter of dogma under the efficient market theory) that this is bad for shareholders because it inhibits the operation of the "market for corporate control"[63] and prevents bad managers from being disciplined.[64] Professor Gilson's bottom line is that "the Delaware Supreme Court could not sustain the regulatory function of directly assessing the merits of target company defensive tactics,"[65] and that Delaware corporate law is "not suited to meeting [the] challenge" of

[59]The two exceptions— the court of chancery's decisions in *City Capital Assocs. Ltd. P'ship v. Interco Inc.*, 551 A.2d 787 (Del. Ch. 1988), and *Grand Metro. PLC v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988)—were disapproved by the Delaware Supreme Court in *Time Warner. See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990).

[60]Moran v. Household International, Inc., 500 A.2d 1346, 1354 (Del. 1985) ("When the Household Board of Directors is faced with a tender offer and a request to redeem the Rights, they will not be able to arbitrarily reject the offer.").

[61]907 F. Supp. 1545 (D. Del. 1995).

[62]*See* Gilson, *supra* note 1, at 500-01.

[63]*Id.* at 495-96.

[64]*See id.* at 495.

[65]*Id.* at 497 (citation omitted).

present corporate realities.[66]

Professor Gilson's solution to this supposed problem is Orwellian: go back to 1984.[67] The mechanism he endorses is a shareholder bylaw repealing the poison pill. Essentially he calls for the overruling of *Household* and the dismantling of the balance struck between offenses and defenses in the 1985 quartet of cases.

The following is a summary of the main points, and some of the chief flaws, in his argument:

- Professor Gilson assumes that the efficient market theory is not only correct, but represents the only rational basis for corporate law decisions. He takes account neither of the doubts about the efficient market theory within the economics profession, nor the weighty legal and public policy considerations that promote values different from those proposed by the efficient market theory.
- Professor Gilson cites no evidence that the current Delaware corporate law inhibits beneficial takeover activity from occurring, or interferes with the maximization of shareholder value when such activity does occur.[68] Professor Gilson does not, and cannot, identify any unduly aggressive takeover defenses adopted or upheld in Delaware in the last decade, nor any transactions "crammed down" by directors against widespread shareholder opposition. Where is the fire Professor Gilson is trying to put out?
- Professor Gilson fails to review the current literature on the shareholder value effects of the Delaware approach, including the poison pill. In fact, the most recent study shows that there is no evidence that, after fifteen years, the poison pill or Delaware's jurisprudence has ever

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[66]Gilson, *supra* note 1, at 493.

[67]*Id.* at 512 ("Shareholder initiated bylaws provide an imperfect, but realistic, way to turn back the clock.").

[68]If Professor Gilson's fundamental premises, that current Delaware law makes hostile bids virtually impossible and that the pill has given management the ability to resist hostile bids without any counterbalance, are valid, one would expect that the volume of hostile bid activity would be low, and that sophisticated participants in the marketplace would recognize the futility of hostile bids and refrain from making them. The reality, of course, is quite the contrary: 1999 alone saw 20 U.S. hostile transactions announced for a total value of approximately $100 billion. *U.S. Hostile Deals 1999*, Nov. 21, 2001, *available at* THOMSON FINANCIAL SECURITIES DATA. Joseph Flom, who spearheaded the 1983-1985 attacks on the pill, has observed that "[t]he Nineties . . . have seen almost total acceptance of hostile takeover activity, with domestic hostile bids being made by major establishment firms such as GE, AT&T, IBM, Pfizer, and Allied-Signal." Joseph H. Flom, *Mergers & Acquisitions: The Decade In Review*, 54 U. MIAMI L. REV. 753, 762 (2000).

detracted from shareholder economic welfare.[69]

- Professor Gilson argues that allowing shareholders to vote down a poison pill would result in a predictable corporate law regime.[70] He offers no support for the patently absurd proposition that shareholders and directors would consider Delaware law "predictable" if Delaware abruptly reversed itself after fifteen years of repeated commitment to the principles of *Unocal* and the other 1985 cases. Rather, if Delaware made the 180-degree turn he advocates, it would be seen as the corporate law equivalent of a banana republic.[71]

- Professor Gilson consistently misunderstands *Unocal*'s relation to pre-1985 Delaware law. He presents *Unocal* as a departure from prior Delaware law in the direction of more deference to directors' ability to block takeovers.[72] In fact, to the extent *Unocal* was a departure at all, it was a departure away from directors' discretion. Before *Unocal*, Delaware law clearly recognized that directors, not shareholders, had authority to determine the corporate response to unsolicited takeover bids. In *Pogostin*,[73] less than one year before *Unocal*, the Delaware Supreme Court applied the plain business judgment rule to directors who "successfully avoided a takeover."[74] Only one part of *Unocal* was new law—the increased burden on directors to justify their decision.

Recent research has discredited Professor Gilson's central claim on his own efficient market theory-driven premises. The work of Professor Robert Daines demonstrates that Delaware's post-1985 legal regime has not reduced returns to shareholders or the frequency of takeover activity in comparison with any other U.S. jurisdiction.[75] As Professor Daines summarizes his conclusions:

> Delaware corporate law improves firm value and facilitates the sale of public firms. Using Tobin's Q as an estimate of

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[69] *See* John C. Coates, IV, *Empirical Evidence on Structural Takeover Defense: Where Do We Stand?*, 54 U. MIAMI L. REV. 783 (2000).

[70] *See* Gilson, *supra* note 1, at 502.

[71] The value of predictability of Delaware law does not just exist to make life easier for directors or practitioners. It is fundamental to the "wealth creation" purpose of the general corporation law that "uncertainty in the definition of corporate rights and duties" be minimized when this is consistent with the enforcement of fiduciary duties. Allen, *supra* note 22, at 899. Predictability is also a prime reason why Delaware has become the paramount domicile for U.S. corporations. *See* Daines, *supra* note 48.

[72] *See* Gilson, *supra* note 1, at 512-13.

[73] 480 A.2d 619 (Del. 1984).

[74] *Id.* at 627.

[75] Daines, *supra* note 48, at 26.

> firm value, I find Delaware firms are worth significantly more than similar firms incorporated elsewhere. The result is robust to controls for firm size, diversification, profitability, investment opportunity and industry. Delaware firms also receive significantly more takeover bids and are significantly more likely to be acquired. Firms with strong incentives to choose valuable legal regimes are likely to incorporate in Delaware when they go public. These results suggest that corporate law affects firm value.[76]

Professor Daines' study is derived from the premise of the efficient market theory but, nonetheless, shows none of the dysfunctional or shareholder-wealth-damaging effects complained of by Professor Gilson.

* * *

Beyond these misconceptions, however, are the false premises underlying the two main building blocks of Professor Gilson's thesis. First, the primacy of the outcomes defined as optimal by the efficient market theory. Second, the notion that "shareholder choice" is (or ought to be) part of the fabric of Delaware takeover law. Following a review of those issues, Gilson's main recommendations—that Delaware should adopt a "shareholder choice" regime by affirming the validity of pill-repeal shareholder bylaws and reduce its doctrinal emphasis on board elections as opposed to market mechanisms—can be dealt with in their appropriate context.

Delaware has never accepted the efficient market theory as a basis for corporate law. In light of the growing evidence that the theory is not only unproven, but is in fact wrong, there is no reason to change now. Throughout the early 1980s, a coalition of corporate raiders and academics urged Delaware courts to change existing Delaware laws concerning the powers and duties of boards confronted with unsolicited takeover bids.[77] The demand was consistently that Delaware should shunt the directors aside. The efficient market theory appeared to support the demand because shareholder welfare would be damaged if any obstacles were placed in the way of the "free market in corporate control."

In 1985, Delaware decided not to adopt the free market in corporate control as an article of faith. Since then, the volume of merger and acquisition activity has increased. The evidence shows that the pill has

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[76] *Id.* at abstract.

[77] *See, e.g.*, Gilson, *supra* note 19, at 845-48.

neither inhibited takeover activity nor reduced shareholder returns. To the contrary, J.P. Morgan & Co.'s two studies, in 1995 and 1997, showed that premiums paid to firms with pills were forty-two percent higher than the market price of the acquired firm's shares five days prior to the initial offer, while companies that did not adopt pills received an average premium of only thirty percent.[78] A 1997 study by Georgeson & Co., and a 1995 study by Robert Comment and G. William Schwert reached similar conclusions.[79]

The persuasiveness of the efficient market theory has itself been thoroughly undermined by developments since 1985 in both research and the real world. Academic economists propose that the assumption that "takeovers are good" is not true even from a narrow wealth-maximizing, shareholder-centric viewpoint. Throughout the 1980s, and even in today's debate, adherents of the efficient market theory have argued that their opponents are advancing a set of non-economic goals. An example of one such goal is the protection of "entrenched" management and avoidance of labor force reduction. It turns out, however, that most hostile deals are simply not successful on economic terms, and that there is no empirical basis for the claims made by efficient market theory partisans that hostile takeovers either increase aggregate returns to shareholders or effectively "discipline" corporate management:

> [D]espite the vigor with which the shareholder theory [i.e., efficient market theory] was propounded in the US in the 1980s, there is a striking dearth of unambiguous evidence to support it, even when the arguments are taken on their own

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[78]JP MORGAN, M&A DEP'T, ANALYSIS POLICY GROUP, POISON PILLS AND ACQUISITION PREMIUMS (July 25, 1997). The 1997 study reflects a nine-year period during 1988-1997 and is based on final offer versus price five days prior to initial offer. *Id.* app. 1. Similarly, JP Morgan's 1995 study, which covered the period during 1988-1995, reflected median control premiums of 51% for companies with a pill, and 36% for companies with no pill. JP MORGAN, M&A DEP'T, ANALYSIS POLICY GROUP, POISON PILLS AND ACQUISITION PREMIUMS (Dec. 18, 1995).

[79]GEORGESON SHAREHOLDER, MERGERS & ACQUISITIONS, POISON PILLS AND SHAREHOLDER VALUE/1992-1996 (Nov. 1997) (indicating a premium of 37% for companies with pills, and 29% for companies without pills, "measured as the price appreciation from one week prior to the announcement of the first bid until the transaction's completion date, net of the change in the S&P 500 index over the same period"); Robert Comment & G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J. FIN. ECON. 3, 31 tbl. 4 (1995) (confirming premium results). *But see, e.g.*, John C. Coates, IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 313 (2000) ("Notwithstanding the consistency and impressiveness of the . . . results, [pill premium] studies showing a correlation between pills and deal premiums are a classic example of correlation not proving causation.").

> terms. . . . [E]ven if we accept the questionable assumption that corporate performance can be adequately proxied by abnormal returns to shareholders, the empirical findings based on the event-study methodology fall short of providing clear-cut support for the alleged benefits of the market for corporate control.
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> * * *
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> The unimpressive returns to acquirer shareholders, as well as concerns about the time consistency of shareholder returns on takeovers, cast doubt on the contention by proponents of shareholder theory [i.e., efficient market theory] that the market for corporate control is a mechanism for disciplining corporate management.
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> * * *
>
> With a few exceptions, most empirical studies of post-acquisition performance have failed to provide strong evidence of the disciplinary role of takeovers and some have even suggested that the market for corporate control reduces economic performance.[80]

While efficient market theory partisans have advanced some evidence, albeit weak and inconsistent, that target-shareholder wealth may be increased by hostile takeovers, they have advanced no evidence that overall shareholder wealth is increased by such activity. Indeed, the empirical research shows the opposite:

> In contrast to the gains of target company shareholders, however, the wealth of acquiring company shareholders showed little change or even decreased around the time of the transaction. . . . Since the bidder firms were, on average, much larger than the targets, the enormous premia paid to target firms did not always imply a positive change in the wealth of the target and acquirer shareholders combined. . . . As Jensen and Ruback concluded: "These post-outcome

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[80] MARY O'SULLIVAN, CONTESTS FOR CORPORATE CONTROL 167-69 (Oxford Univ. Press 2000) (emphasis added).

> negative abnormal returns are unsettling because they are inconsistent with market efficiency and suggest that changes in stock price during takeovers overestimate the future efficiency gains from mergers."[81]

Moreover, the efficient market theory proponents fail to explain why corporate law should be designed to protect abnormal returns to a small class of shareholders as opposed to shareholders generally.[82]

Even the assumption that increased shareholder activism contributes to shareholder welfare and economic gains by "disciplining" a presumptively defective group of managers turns out to lack empirical support. Professor Bernard Black, generally a proponent of efficient market theory, has conceded: "On the whole, [studies] offer no convincing evidence that shareholder activism affects bottom line performance. . . . [T]he general absence of convincing evidence of a relationship between activism and firm performance suggests that activism does not have a major impact on firm performance."[83]

The most recent challenge to the assumed primacy of the efficient market theory within the context of academic financial economics has come from the "behavioral economics" school:

> Whereas conventional finance theorists assume that only "rational" behavior affects equity prices, behavioral finance theorists argue that how people actually behave makes a difference to stock prices. Specifically, behavioral finance is based on the observation (based on cognitive psychology and

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[81] *See id.* at 168 (citing Sanjai Bhagat et al., *Hostile Takeovers in the 1980s: The Return to Corporate Specialization, in* BROOKINGS PAPERS: MICROECONOMICS 1-84 (1990)) (quoting Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control, The Scientific Evidence*, 11 J. FIN. ECON. 5, 20 (1983)).

[82] As Warren Buffett stated:

> The sad fact is that most major acquisitions display an egregious imbalance: They are a bonanza for the shareholders of the acquiree; they increase the income and status of the acquirer's management; and they are a honey pot for the investment bankers and other professionals on both sides. But, alas, they usually reduce the wealth of the acquirer's shareholders, often to a substantial extent.

Letter from Warren Buffett, *Chairman's Letter to the shareholders of Berkshire Hathaway, Inc.*, 1994 Annual Report (1995); *see also* Allen, *supra* note 22, at 895 (stating that corporation law is, fundamentally, intended to produce "[a] net increase in total wealth").

[83] Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States, in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 462 (Peter Newman ed., Stockton Press 1998).

> decision theory) that in some circumstances humans make systematic errors in judgement and that these behavioral biases affect equity prices.[84]

Furthermore, the propositions of the efficient market theory were never part of classical economists' thinking:

> Veblen, Schumpeter and Keynes . . . emphasized the possibility, and indeed the likelihood, that there will be long periods of dislocation between the financial and the real sectors of the economy because they considered that the stock market evolves through a path-dependent process which is historically specific and subject to a different dynamic than that which affects the real economy. Their conclusions are thus even more threatening to the theory of shareholder governance than the arguments made by behavioural [sic] finance theorists.[85]

A recent review of the economic literature on the shareholder-wealth effects of takeover defenses was undertaken by Professor John C. Coates[86] and concluded:

> Delaware courts should take some comfort from the fact that they resisted strong academic arguments and political efforts that attempted to push them to dramatically repudiate pills and other structural defenses. The empirical case against defenses remains unproven, and, without empirical support, the theoretical case against defenses is not as compelling as it might have seemed to hostile commentators [in 1989].[87]

As Professor Coates explains:

> [P]ill event studies produced little reliable evidence on the wealth effects of takeover defenses. Within a given study, results are mixed and weak; between studies, results are inconsistent; over time, results have become less

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[84] *See* O'SULLIVAN, *supra* note 80, at 206-07.
[85] *Id.* at 208.
[86] Coates, *supra* note 69.
[87] *Id.* at 797 (citations omitted).

> significant . . . . [E]vent studies do not provide much, if any, support for theoretical . . . arguments that such defenses harm shareholders or normative arguments that such defenses should be prohibited.[88]

Professor Coates observes that the 1980's studies were based on "tiny" samples and that the results of at least one early, influential study were "overstated" by its author and then "parroted ever since."[89] Indeed, Professor Gilson acknowledges that it is only the "semistrong" version of the efficient market theory that is persuasive, and even he recognizes that at least some takeover bids reflect temporary market mispricing.[90] Professor Gilson's own summary of the empirical support for the efficient market theory is quite candid about the inherently speculative nature of the hypothesis:

> Development of the empirical evidence on [the efficient market theory] must begin with a number of caveats. First, we don't know what the "right" price for an asset is. Thus, we can't test [the efficient market theory] directly. . . . This means that we can never prove that a market *is* efficient. . . .
>
> Second, even in its semistrong form, [the efficient market theory] is an extreme null hypothesis that can't be strictly true. . . . [T]here must be enough inefficiency to induce investors to search for and trade on mispricing—an equilibrium level of inefficiency.[91]

Professor Gilson also concedes that the verifiability of the efficient market theory is limited by "the noisiness of stock prices" and by the fact that the

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[88] *Id.* at 787. Professor Coates identifies two significant design problems with the "event studies" that have been used to measure the effects of poison pill adoption on shareholder returns—they all fail to realize that "pill *adoptions* by particular firms rarely have . . . effects on bids because of the possibility of later adoption." *Id.* at 791. Furthermore, they all fail to take into account the presence or absence of other structural takeover defenses (i.e., staggered boards and charter provisions regulating director removal). *Id.* at 792-93.

[89] *Id.* at 788 n.20 (citing Gregg A. Jarell & Annette B. Poulsen, *Shark Repellents and Poison Pills: Stockholder Protection—From the Good Guys or the Bad Guys?*, 4 MIDLAND CORP. FIN. J. 39, 128 (1986)).

[90] RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 135-36 (2d ed. 1995).

[91] *Id.* at 137-38 (citing Sanford Grossman & Joseph Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393, 393 (1980)).

efficient market theory assumes the finance economists' "Capital Asset Pricing Model" is correct.[92] Finally, he acknowledges that the 1987 stock market crash appears inconsistent with the efficient market theory and that since "the 1987 market crash, many finance scholars are skeptical about absolute pricing efficiency."[93]

Since even Professor Gilson admits doubts about the efficient market theory, it is hardly incumbent upon Delaware to abandon its successful corporate law framework in favor of a questionable hypothesis supported by proponents who admit, at least in their more candid writings, that it is subject to real doubt.[94]

To descend from the level of theory to the concrete cases that confront judges and practitioners, the fundamental question for Delaware has always been straightforward: must we accept, and make boards accept, short-term trading value as the sole reference point in responding to takeover proposals? If Delaware had accepted the urgings of the efficient market theory proponents in the 1980s, any company under-valued by the stock market in those years would have been available for sale at a slight premium. Can anyone doubt that many of those companies and their shareholders gained by remaining independent and contributing to the approximately 1,000% rise in aggregate stock market value since then? By the same token, should any board have been pressured by a Delaware rule of conduct during the NASDAQ bubble of 1999-2000 to accept patently over-valued securities from a dot.com or other temporarily high-flying buyer? In short, the Delaware compromise of 1985 has protected

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[92] *See id.* at 138-39. "[D]espite the centrality of the [efficient market theory] to financial economics, its empirical status is highly questionable. The hypothesis cannot, in fact, be empirically tested in isolation from assumptions about the way in which economic actors price securities.... As Fama put it, 'Market efficiency per se is not testable.'" O'SULLIVAN, *supra* note 80, at 170 (quoting Eugene Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575, 1575 (1991)).

[93] GILSON & BLACK, *supra* note 90, at 139. As Professor Gilson himself recognizes, the unreliability of the efficient market theory undermines the entire critique of takeover defenses:

> Semistrong market efficiency has important implications for takeover policy. If shareholders are good at valuing public companies, that strengthens the case for a relatively free market in corporate control—for letting shareholders decide whether a target should be sold. Conversely, if shareholders are prone to irrational fads, that strengthens the case for giving the target's board of directors some discretion to resist a takeover proposal that the shareholders would endorse.

Id. at 136.

[94] Indeed, one of the founding architects of the efficient market theory stated that stock prices were accurate "within a factor of 2 of value, i.e., the price is more than half of value and less than twice value. The factor of 2 is arbitrary, of course." Fischer Black, *Noise*, 41 J. FIN. 529, 533 (1986) (citation omitted). It is hard to see why a theory of this nature should lead courts to the view that directors should be stripped of the ability to oppose takeover bids.

shareholders, corporations, and directors from pressure to respond immediately to short-term dislocations in the stock market. Advocates of the efficient market theory contend that such dislocations are theoretically impossible,[95] but tell that to directors and investors who have lived through them.

"Shareholder choice" is not a paramount value in Delaware law, and does not represent the "default rule" under the Delaware corporation statute. "Shareholder choice" has been a popular slogan of the partisans of efficient market theory. While the theory has in fact favored non-choice mechanisms such as tender offers, over time the efficient market theory proponents increasingly sought to situate their position as part of a "good corporate governance" movement. But the entire discourse about "shareholder choice" has been distorted by the efficient market theory partisans' unwillingness to admit that the poison pill does not nullify "shareholder choice." There is one critical place in the statutory scheme for "shareholder choice", as both *Unocal* and *Household* pointed out. "Shareholder choice" is exercised in elections for corporate directors: "If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out."[96] The debate is not about the existence of "choice," but the mechanism through which that choice can be expressed.

Proponents of "shareholder choice" often assume that corporate governance by referendum is a self-evident good or right, but typically fail to engage either the case law or the statutory scheme. Those who would make "shareholder choice" a paramount value in crafting case law

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[95]The efficient market theory argument of last resort is often the claim that Delaware's supposedly overly "managerialist" rules decrease shareholder wealth and market efficiency because there are "bids that never get made." *See, e.g.*, Michael Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. FIN. ECON. 377 (1988). Surely such a claim, which is inherently unverifiable, asks only one third of the relevant questions: (1) are there in fact bids that "don't get made"?; (2) are there not also value-enhancing friendly deals that only get made because of Delaware's post-*Time Warner* assurance that entering into a friendly stock merger does not put the firm in play?; and finally, (3) is the net result of the foregoing two questions positive or negative for short or long-term shareholder wealth? Needless to say, solving this equation would require knowledge available to omniscient deities, but not to academics or judges. Nevertheless, "the scientific evidence to date provides no evidence that pill adoptions deter bids or affect bid outcomes." Coates, *supra* note 79, at 297; *accord* Comment & Schwert, *supra* note 79, at 3. "Antitakeover measures increase the bargaining position of target firms, but they do not prevent many transactions." *Id.*

[96]Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985) (citing Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1985); DEL. CODE ANN. tit. 8, §§ 141(k), 211(b) (2000)). *Household* made the same point. *See also* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354 (Del. 1985) (listing which shareholders may remove their boards).

applicable to defensive tactics must first face the clear language and structure of the statute. "Even in the traditional areas of fundamental corporate change, i.e., charter amendments, mergers, sale of assets, and dissolution, director action is a prerequisite to the ultimate disposition of such matters."[97] In short, Delaware has by statute decided that control of the corporation should not change without the concurrence of the directors, except by election of new directors. Under the Delaware statute, there is no contemplation of a control change unapproved by a board of directors. The "shareholder choice" provided by the statute is the right to choose representatives periodically, not the right of perpetual self-governance through instant polls or plebiscites.

Whether this legislative allocation of power is wise or unwise is not for the courts to decide. It is part of the deep design of the Delaware corporate form. It is beneficial because directors are presumed to know more about the value of the corporation and its business prospects than shareholders, and directors have the ability to respond to third parties in a way that disaggregated public shareholders do not.[98] For these and other reasons, the Delaware legislature has decided that Delaware corporations should be representative democracies.[99] Corporate decisions are made by the corporate governors (the board), and in certain cases need to be ratified by the electorate (the shareholders). The statute does not contemplate that "fundamental" corporate decisions be made by the corporate equivalent of a voter initiative or a plebiscite. In fact, Delaware law does not even permit a board to submit a merger proposal to shareholders without a recommendation, i.e., the board cannot delegate to shareholders the primary judgment whether a merger is good or bad.[100]

The importance of the informational advantage enjoyed by directors

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[97]*Unocal*, 493 A.2d at 954 n.8 (citing DEL. CODE ANN. tit. 8, §§ 242(b), 251(b), 252(c), 253(a), 254(d), 271(a), 275(a) (2000) (citations omitted)).

[98]*See* Lipton, *supra* note 18, at 114-20; Lipton, *supra* note 23, at 45.

[99]*See, e.g.*, TW Servs., Inc. v. SWT Acquisition Corp., No. 10,427, 1989 Del. Ch. LEXIS 19 (Del. Ch. Mar. 2, 1989), *reprinted in* 14 DEL. J. CORP. L. 1169 (1989) ("While corporate democracy is a pertinent concept, a corporation is not a New England town meeting; directors, not shareholders, have responsibilities to manage the business and affairs of the corporation, subject however to a fiduciary obligation."). *Id.* at *29, *reprinted in* 14 DEL. J. CORP. L. at 1186 n.14.

[100]*See* DEL. CODE ANN. tit. 8, § 251(b)-(c) (2000).

> The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation. . . . The agreement . . . shall be submitted to the stockholders of each constituent corporation at an annual or special meeting for the purpose of acting on the agreement.

Id.

was recognized in the development of the "substantive coercion" strand of the doctrine in *Time Warner* and *Unitrin*.[101] The courts' acknowledgment that directors can respond to the threat of "substantive coercion" is essentially a recognition that shareholders may "get it wrong" because information about a company's value may not either be fully available or fully understood by all shareholders, and that avoiding such a result is an appropriate goal for directors. Shareholders are not infallible. As such, Delaware's treatment of "substantive coercion" is not a bizarre malformation of doctrine as Professor Gilson would classify it.[102] It is a doctrinal manifestation of the legislative judgment embodied in sections 141, 242(b), 251(b), 252(c), 253(a), 254(d) and 271(a),[103] that board action is necessary whenever a "fundamental corporate change" is to occur because the board is the best-informed decision maker when the issue is the value of the enterprise.[104]

The one effort to introduce an express "shareholder choice" principle into Delaware law occurred in late 1988, in the court of chancery's decisions in *Interco*[105] and *Pillsbury*.[106] The *Interco* case is especially noteworthy, as it was the first case that restricted the power of a board to

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[101]It is ironic that the Delaware courts took the "substantive coercion" phrase from an article of which Professor Gilson was co-author. *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1153 n.17 (Del. 1990) (quoting phrase from Ronald Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 267 (1989)); Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1384 (Del. 1995)).

[102]*See* Gilson, *supra* note 1, at 498 n.23.

[103]"The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation and declaring its advisability." *See* DEL. CODE ANN. tit. 8, § 251(b) (2000). "The terms of the agreement may require that the agreement be submitted to the stockholders whether or not the board of directors determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the stockholders reject it." *See also id.* § 251(c).

[104]Indeed, there is a real question as to whether public shareholders could ever achieve sufficient informational parity with directors to justify a "shareholder choice" rule. The proponents of the efficient market theory, and others, blithely assume that because federal law requires some disclosures under the Williams Act and because Delaware imposes a duty to disclose "all material facts" concerning a transaction where a shareholder vote is sought at the time of a takeover, shareholders will know as much about the value of the company as the directors. It is hard to imagine this presumption being true in real life. The information available to boards, both quantitative and qualitative, will always be greater than what can be broadcast to shareholders. Moreover, it may well be highly detrimental to corporate and shareholder welfare to require disclosure of competitively sensitive business plans and other valuable secrets, solely in order to attempt to raise shareholders to a level of informational parity with directors.

[105]City Capital Assocs. Ltd. P'ship v. Interco. Inc., 551 A.2d 787 (Del. Ch. 1988).

[106]Grand Metro. PLC v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988).

"just say no." The Interco board rejected a fully-financed, all-cash, all-shares premium bid from a well-known corporate raider, claiming the bid was inadequate.[107] As was typical at the time, the board attempted to create an alternative, superior transaction to counter the hostile bid.[108] The board adopted a restructuring proposal that duplicated the hostile bidder's post-acquisition strategy— increased leverage and the sale of some lines of business.[109] Interco's board argued that the restructuring proposal would give its shareholders the full profits that would otherwise have been shared with the bidder if the hostile offer prevailed.[110] The court of chancery applied *Unocal* to the board's actions and concluded that a poison pill could not be used to prevent indefinitely the stockholders from considering a fully financed, all-shares, all-cash tender offer.[111] Rather, according to the court of chancery, once a period of fashioning potentially superior alternatives had passed, and the "end stage" had been reached, the board had to permit the shareholders to choose. Similarly, in *Pillsbury*, the court of chancery concluded that the board could not keep its pill in place in response to a tender offer, even if the decision not to redeem the pill was in accordance with the board's good faith business judgment.[112] Fortunately, the Delaware Supreme Court in *Time Warner* found this position inconsistent with the fundamental Delaware law principles discussed above, in effect reversing *Interco* and *Pillsbury* on this point.[113]

If the *Interco* and *Pillsbury* decisions had prevailed, the poison pill's effectiveness would have been completely undermined. Courts would have substituted their judgment of what is a "better" deal for that of a corporation's board of directors, and the proponents of the efficient market theory would have prevailed. Fortunately, the *Time Warner* court rejected this proposition and expressed its disapproval of the *Interco* court's narrow construction of *Unocal*.[114] According to the supreme court, inadequate

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[107]*See Interco*, 551 A.2d at 792.

[108]*Id.* at 793.

[109]*Id.*

[110]*Id.* at 794-95.

[111]*See Interco*, 551 A.2d at 798.

[112]*Pillsbury*, 558 A.2d at 1060.

[113]Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1990).

> To the extent that the Court of Chancery has recently [substituted its judgment as to what is a "better" deal for that of a corporation's directors] in certain of its [recent] opinions, we hereby reject such [approval] . . . as not in keeping with a proper *Unocal* analysis. *See, e.g., Interco*, 551 A.2d [at] 787, and its progeny . . . .

Time Warner, 571 A.2d at 1153.

[114]*Time Warner*, 571 A.2d at 1153.

value is not the only legally cognizable threat that a bidder's all-cash, all-shares offer could present.[115] "The open-ended analysis mandated by *Unocal* is not intended to lead to a simple mathematical exercise."[116] Rather, the "precepts underlying the business judgment rule militate against a court's engaging in the process of attempting to appraise and evaluate the relative merits of a long-term versus a short-term investment goal for shareholders."[117] The court's decision in *Time Warner* restored the board of directors' authority to evaluate and reject, if appropriate and in accordance with its good faith business judgment, a takeover bid, thereby putting an end to the question of whether a board can "just say no."

As Vice-Chancellor Strine has noted, "[T]he director-centered model won [the Eighties debate on takeover rules]."[118] But how could the outcome have been otherwise, given the "director-centered" design of the Delaware General Corporation Law itself? In much of its 1980's takeover jurisprudence, the Delaware Supreme Court was not choosing between different models of corporate governance based on their abstract merits. Instead, the court was taking direction from the statutes, evidenced by the court's repeated reliance upon the "director-centered" rules of sections 141, 242(b), 251(b), 252(b) and the other relevant statutes.[119]

Because there is no specific enactment under the Delaware statute embodying a director veto on tender offers, it has been said that "the default rule" under the statute is that shareholders are unilaterally permitted "as a class" to accomplish the sale of the corporation.[120] This may describe an empirical fact prior to 1985, but it does not accurately describe the structure of the statute. The statute was enacted well before tenders were contemplated, but what it states about allowable mechanisms for change in corporate control is unmistakable. The "default rule" claim is really a newly christened version of the argument frequently made by academics and raiders in the 1980s that shareholders of Delaware corporations have a "right" to receive or participate in tender offers. This argument was

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[115]*See id.*

[116]*See id.*

[117]*See id.*

[118]Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919, 925 (2001).

[119]Citation and discussion of the powers accorded to directors by the statute occurs at crucial moments in all the landmark 1980's Delaware Supreme Court opinions. *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1990); Revlon Inc. v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173, 179 (Del. 1986); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1353 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 953-54 (Del. 1985); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

[120]*See* Strine, *supra* note 118, at 924-25.

expressly made and rejected in *Household* itself: "Plaintiffs' claim that Household's adoption of the Rights Plan deprived stockholders of the 'right' to participate in two-tier tender offers does not stand analysis. The principal exponent of such a 'right,' Professor Jensen, was unable to point to a specific legal basis for the right."[121]

The structure of the statute makes it clear that the Delaware Supreme Court was correct in declaring in *Unocal* that "director action is a prerequisite to the ultimate disposition" of matters affecting "fundamental corporate change."[122] *Unocal*'s reading of the statute is incompatible with a reading that considers direct shareholder decision making as the default rule. There is no Delaware statutory provision that deals with a fundamental corporate change and provides for direct or unilateral shareholder decision making. Such direct and unilateral power is given to shareholders only at election time.

III. ELECTIONS VERSUS TENDERS

Professor Gilson's article also showcases his view that the Delaware courts have placed too much emphasis on voting and elections as a means of transferring corporate control, and that this emphasis has come at the expense of his preferred method referred to as the "marketplace" method of the tender offer.[123] Professor Gilson prefers transfers by marketplace mechanisms to elections because they are faster.[124] He also seems to think that hostile tender offers are effectively foreclosed in Delaware since the *Unocal* standard is so hollow or easily manipulated that any response to

[121]Moran v. Household Int'l, Inc., 490 A.2d 1059, 1079 (Del. Ch. 1985).

[122]*Unocal*, 493 A.2d at 954 n.8.

[123]Gilson, *supra* note 1, at 503-04. The suggestion that the Delaware courts have indulged some sort of "unexplained" ideological "preference that control contests be resolved through elections rather than market transactions," *id.* at 492, is among the more remarkable aspects of Professor Gilson's article. In truth, the blind obedience to ideology in this debate is all with Professor Gilson and his allies. The Delaware decisions are not "unexplained" or "inexplicable" at all. To the contrary, *Unocal* and *Unitrin* are anchored in a long tradition of corporation law and statutory law that confines key corporate decisions to directors in the first instance. The Delaware decisions reflect the fundamental structural choices of the Delaware General Corporate Law and are faithful to the specific commands of statutory text. For this Delaware decisions have earned reaffirmation by fifteen years of success in practice. To support the revolution Professor Gilson proposes by contrast requires "inexplicable" ideological attachments. To unwind what *Unocal* has settled would break away from the traditional separation of corporate powers, gratuitously overthrow an effective scheme of corporate law, and offend both the spirit and letter of the Delaware statutes. All this in the service of an admittedly unprovable economic theory that has been substantially discredited by real world events.

[124]*Id.* at 504.

any threat will be accepted by the Delaware courts, and that those courts have essentially abandoned any role in policing the use of the pill.[125]

Each of these points is either incorrect or irrelevant to courts crafting a regime of corporate law. Tender offers may indeed be faster than elections, but that says nothing about whether they are more desirable or consistent with corporate law values. Moreover, Professor Gilson appears to misunderstand the burden that a board has under *Unocal* and *Unitrin* to "stand behind the pill," remarking that a board can merely "assert" that the underlying long-term value of the corporation exceeds the bid on the table.[126] In fact, in the two cases in which a "just say no" defense was actually attempted in a court, the directors were required to show through detailed presentations and expert testimony that their "assertion" was reasonable and based on appropriate information.[127]

Professor Gilson also treats the "preference" for elections as new, and he considers it a hard-to-explain development. In fact, the basic model of Delaware corporate governance has always viewed elections and shareholder voting both as critical elements in "fundamental corporate changes" as well as the safety-valve by which shareholders can ultimately override the wishes of a board with whom they disagree. As noted, the Delaware corporate statute provides for shareholder votes to ratify board recommendations for "fundamental corporate change," and Delaware case law has long recognized that the statute creates a representative form of corporate governance in which the electorate's residual power is expressed through periodic elections, and not through plebiscitary, initiative or market mechanisms.[128]

In criticizing the Delaware courts for their supposedly "unexplained" preference for elections, Professor Gilson ignores the fact that the courts have been emphasizing that elections are the critical method of shareholder review of board responses to takeover proposals. The courts have imposed a new judge-made standard to directorial conduct that may affect the outcome of elections through adoption of a "compelling justification"

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[125]*Id.* at 508. *But see* Flom, *supra* note 68 (discussing the volume of hostile transactions in the 1990s).

[126]Gilson, *supra* note 1, at 501.

[127]*See* Amanda Acquisition Corp. v. Universal Foods Corp., 877 F.2d 496, 500-01 (7th Cir. 1989); Moore Corp. Ltd. v. Wallace Computer Servs., Inc., 907 F. Supp. 1545, 1558-60 (D. Del. 1995).

[128]*See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985).

standard[129] within *Unocal/Unitrin*.

With respect to the pill repeal bylaw, Professor Gilson's arguments are marshaled to the conclusion that Delaware should undo the current balance between the advocates of "shareholder choice" and the advocates of plain-business-judgment-rule review of takeover defense. The technique endorsed by Professor Gilson is the pill repeal shareholder bylaw. As shown above, validation of these bylaws would completely undermine the Delaware Supreme Court's reading of sections 141, 242(b), 251(b), and 252(b) in *Unocal* and its progeny.[130] Delaware's statutory scheme of representative corporate democracy would be replaced with government-by-initiative, and the practical benefits of the pill (such as deterrence of unfair takeover tactics; protection from "creeping" acquisitions; increased time and negotiating authority for the board to consider alternatives or conduct an auction) would be swept away.

All this would be done in the name of a bankrupt, or at least questionable academic, theory of the efficient market and a concept of "shareholder choice" that is at odds with the fundamental structure of Delaware's corporation statute.[131] In addition, validation of the bylaw would be at odds with the Delaware Supreme Court's recent decision in *Quickturn*, which stressed the integrity of the grant of power under section 141(a) to the board to "manag[e] the business and affairs of [the] corporation."[132] *Quickturn*'s rationale, that the statute confers inviolate powers and rights to directors to discharge their fiduciary duties under

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[129]This "compelling justification" standard is otherwise known as the *Blasius* standard. Blasius Indus. Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988) (holding that the "board bears the heavy burden of demonstrating a compelling justification for [franchise-impairing] action").

[130]Moreover, Professor Gilson's treatment of the practical problems associated with validation of the bylaw is almost flippant. He glides over the potential for validating stockholder-adopted bylaws that would attempt to control the "business and affairs of the corporation," such as bylaws that would instruct the board as to what investments they could make or what compensation they could pay. *See* Gilson, *supra* note 1, at 509. He even believes that there would be no problem with a system in which the stockholders could order mandatory redemption of the pill on one day, and the board would be free under *Household*, to put the pill in the following day, and on and on. *Id.* at 511 n.62. "For present purposes, it is sufficient to note that even [the problem of recursive bylaw adoptions by shareholders and director action, first repealing and then reinstating poison pills,] is better than the present situation." *Id.*

[131]It is noteworthy that each of the leading Delaware law firms specializing in corporation law have issued reasoned opinions to clients advising that the pill-repeal bylaw is inconsistent with Delaware statutory and decisional law. *See, e.g.*, Novell Inc., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 212, at *1 (Feb. 14, 2000) (referencing the opinion of Morris, Nichols, Arsht & Tunnell that the proposed pill-redemption bylaw would be an improper subject for shareholder action under Delaware law).

[132]Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291 (Del. 1998).

section 141(a), is not reconcilable with a bylaw that allows the stockholders to limit and overrule the board's employment of a device approved by the courts to further the exercise of those duties. Professor Hamermesh's article ably states the reasons why the bylaws are invalid under Delaware law as a matter of statutory construction.[133]

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Professor Gilson's article is, at bottom, only one of the more recent examples of a twenty-year-long effort by the efficient market theory partisans to reinterpret and distort the carefully crafted, time-tested business judgment rule to fit their pre-determined preference for a totally new rule. With the zeal typical of adherents to abstract and unverifiable dogmas, they have continued to press the Delaware courts to abandon the business judgment rule despite their complete failure to produce evidence that *Unocal*, *Unitrin*, and their siblings are hurting corporate governance, impoverishing shareholders, or impeding economically desirable transactions. There is no need now to change the well-reasoned and well-understood rules based on *Unocal/Unitrin*.

[133]Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 419 (1998). "The statutes creating general authority to adopt by-laws may not be construed to permit stockholders to adopt by-laws directly limiting the managerial power of the board of directors." *Id.*