Twenty-Five Years After *Takeover Bids in the Target's Boardroom*: Old Battles, New Attacks and the Continuing War

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*By Martin Lipton**

A quarter century has passed since publication of *Takeover Bids in the Target's Boardroom* [1] In that time, we have witnessed the evolution and integration of the ideas presented in *Takeover Bids* into common law and amendments to state corporate law statutes The core principles presented in the article sparked numerous academic and policy debates, most of which focused on varying aspects of shareholder "self-determination" and on the scope of a board's ability to take unilateral measures that the board considered to be in the best interests of the corporation I am pleased to reflect, twenty-five years later, on the current state of discussion regarding the theories contained in *Takeover Bids*

As I explore my own perspectives, I am reminded of the primary impetus for *Takeover Bids*—a concern that the business judgment rule and the board's fundamental gatekeeping role were severely threatened by calls for director passivity in the context of hostile takeover attempts At its core, *Takeover Bids* argued that a corporation's board of directors should be permitted, and indeed has a duty, to manage actively the business of the company, and that its discretion in doing so should not depend on the nature of the particular issue that is being decided (so long as the board satisfies its fiduciary duties) Those theories—a rejection of board passivity, an endorsement of the board as gatekeeper and an active role by the board in the context of hostile takeover bids—became part of the public discourse after the publication of *Takeover Bids* and were ultimately affirmed, either tacitly or explicitly, by both common law and legislative guidance In short, that battle was won

But there is little rest for the battle-weary Self-described "reformers" of the post-Enron era are now mounting a more trenchant, multi-level and multi-

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

jurisdictional attack on the ability of the board and management to manage effectively the corporation Emboldened by the far-reaching regulations adopted in the wake of Enron, WorldCom and similar scandals, some regulators, academics, special-interest shareholders[2] and lawyers who represent shareholder plaintiffs in derivative and class actions continue to demonize the American corporation and offer purported cures to "Enronitis"—cures that in a number of respects may be worse than the disease Proposals to over-engineer board composition, adopt stricter definitions of director independence, limit the amount and form of executive compensation and increase "shareholder power," coupled with increasing displays of influence by special-interest shareholders (through, for example, withhold-the-vote campaigns and insistence on personal contributions by directors to the settlement of derivative lawsuits), once again threaten to erode the fundamental principles that underlie the business judgment rule and that enable the board to function in an entrepreneurial manner At the level of state common law, new theories of director liability also threaten to restrict further a board's effective exercise of its business judgment If successful, these attacks may result in making boards a mere conduit for shareholder referenda, thus rekindling the very theories of director passivity that prompted *Takeover Bids*

I. THE FIRST WAVE OF VICTORIES: CONSTITUENCY STATUTES, PILLS AND DELAWARE JURISPRUDENCE

At the heart of my argument in *Takeover Bids* was one simple premise—that the board of directors is *the* gatekeeper for significant business transactions As such, the board must evaluate any such transaction in accordance with its fiduciary duties and must have the ability—and indeed the obligation—in all circumstances to take actions that it deems necessary and in the best interests of the corporation and its shareholders In the context of transaction structures other than a tender offer (for example, a merger or a sale of substantially all of the corporation's assets), this role and obligation of the board generally have been incorporated into the state statutory landscape In Delaware, both mergers and sales of substantially all assets must be approved by the board prior to being submitted for any required shareholder vote Moreover, the business judgment rule, which as a general matter dictates deference to good-faith board judgments, generally applies to board determinations relating to those transaction structures. *Takeover Bids* argued that the business judgment rule should have no less relevance in the context of hostile takeovers than in the context of any other board decision With this theoretical foundation, *Takeover Bids* presented arguments that quickly would take center stage in public discourse on fiduciary duty—namely, that directors are not required to accept a takeover bid simply because it represents a premium to market and that directors may, and indeed should, consider, in addition to the interests of the company's shareholders, the effect of the proposed

2 In this article, I use the term "special-interest shareholders" to refer to groups, such as public employee pension funds managed by politicians and labor union pension funds, whose agendas may be contrary to the interests of the company or its shareholders

takeover on the long-term interests of the company and on the company's employees, communities, customers, suppliers and other key constituencies

The concept of considering non-shareholder constituencies as well as the long-term interests of the company and its shareholders sparked a wave of state lawmaking, much of it fueled by the heightened hostile takeover environment of the early 1980s Beginning with Pennsylvania in 1983, a large number of states[3] adopted statutory provisions specifically allowing (and in very few cases obligating) boards to consider non-shareholder factors such as the interests of employees, customers, suppliers and local communities, as well as the long-term interests of the company Although the statutes vary in form and scope of permissible considerations of non-shareholder constituencies, they all contributed to a key result—a rejection of the concept of board passivity and an expansion of the permissible universe of factors for boards to consider consistent with their fiduciary duty of care and in the exercise of their business judgment [4]

Although Delaware did not adopt a constituency statute, its judiciary reacted to the evolving takeover defense environment and in so doing adopted the core principles espoused in *Takeover Bids* In the seminal *Unocal* decision, the court for the first time articulated an "enhanced scrutiny" standard for evaluating a

3 Approximately thirty states currently have constituency statutes in effect (Nebraska, however, repealed its statute in 1995) *See* ARIZ REV STAT ANN § 10-2702 (West 2004), CONN GEN STAT ANN § 33-756(d) (West 1997), FLA STAT ANN § 607 0830 (West 2001), GA CODE ANN § 14-2-202(b)(5) (Lexis 2003), HAW REV STAT § 414-221(b) (2004), IDAHO CODE § 30-1702 (Michie 2005), 805 ILL COMP STAT 5/8 85 (West 2004), IND CODE ANN § 23-1-35-1(d) (Michie 1999), IOWA CODE ANN § 491 101B(1) (West 1999), KY REV STAT ANN § 271B 12-210(4) (Michie 2003), LA REV STAT ANN § 12 92(G) (West 1994), ME REV STAT ANN tit 13-C, § 831(6) (West 2005), MASS GEN LAWS ANN ch 156B, § 65 (Lexis 2005 Supp), MINN STAT ANN § 302A 251 subd 5 (West 2004), MISS CODE ANN § 79-4-8 30(f) (Lexis 2001), MO REV STAT § 351 347 (2000), NEV REV STAT 78 138(4) (2000), N J STAT ANN § 14A 6-1(2) (West 2003) , N M STAT ANN § 53-11- 35(D) (Michie 2001), N Y [BUS CORP] LAW § 717(b) (McKinney 2003), N D CENT CODE § 10-19 1-50(6) (Michie 1995), OHIO REV CODE ANN § 1701 59(E) (Lexis 2004), OR REV STAT § 60 357(5) (2001), 15 PA CONS STAT ANN § 1715 (West 1995), R I GEN LAWS § 7-5 2-8 (Lexis 1999), S D CODIFIED LAWS § 47-33-4 (West 2004), TENN CODE ANN § 48-103-204 (Lexis 2002), VT STAT ANN tit 11A, § 8 30(a) (Michie 2004 Supp), WIS STAT ANN § 180 0827 (West 2002), WYO STAT ANN § 17-16-830(e) (Lexis 2005)

4 It is interesting to note that the Company Law Reform Bill that is currently pending in Great Britain similarly reflects the view that directors should "take a properly balanced view of the implications of decisions over time and foster effective relationships with employees, customers and suppliers, and in the community more widely" CORPORATE LAW AND GOVERNANCE COMPANY LAW REFORM WHITE PAPER MARCH 2005 at 20, *available at* http //www dti gov uk/cld/review htm (last modified Mar 2005) In this regard, the text of the proposed law would state that the board must

> take account (where relevant and so far as reasonably practicable) of—
> (a) the likely consequences of any decision in both the long and the short term,
> (b) any need of the company—
> (i) to have regard to the interests of its employees,
> (ii) to foster its business relationships with suppliers, customers and others,
> (iii) to consider the impact of its operations on the community and the environment, and
> (iv) to maintain a reputation for high standards of business conduct, and
> (c) the need to act fairly as between members of the company who have different interests

Company Law Reform Bill, pt B, ch 1 § B3-3 (2005), *available at* http //www dti gov uk/cld/4 pdf (last modified Mar 2005)

board's adoption of a takeover defense mechanism (in that case, a defensive self-tender). The *Unocal* test placed the burden on the board to show (1) reasonable grounds for believing a threat to the corporation existed and (2) that the defensive measure at issue was reasonable in relation to the threat posed The proportionality requirement of *Unocal* specifically mandates that the board focus on the overall effect of the takeover bid on the corporate enterprise Relevant considerations in this regard, the Delaware court noted (referring to an article of mine based on *Takeover Bids*), include questions of legality and the impact of the takeover bid on non-shareholder constituencies [5] Moreover, in addition to broadening the scope of the board's business judgment to include additional constituencies, the *Unocal* court acknowledged the board's role as gatekeeper and specifically rejected the notion of the board as a "passive instrumentality"[6]

The *Unocal* decision indicated Delaware's acceptance of the principle that, in matters of fundamental corporate change (such as a takeover), boards indeed have a threshold role, and that in satisfying this role directors must adhere to standards of business judgment established at common law It naturally followed, then, that there should be a tangible means to reflect this reality hence the shareholder rights plan, or "poison pill"—the now widely-adopted mechanism by boards that, unless removed or amended by the board, dilutes the ownership stake of a hostile acquiror and therefore makes the hostile acquisition unacceptably expensive Having previously established the board's gatekeeper role in the face of a takeover attempt, the Delaware court validated a board's adoption of the poison pill as a defensive mechanism that satisfied the *Unocal* standard [7] Although the analysis of the validity of a rights plan as a defense mechanism will remain contextually dependent—and may in some cases be found to fall short of satisfying the requirements of *Unocal*[8]—few can argue with the proposition that shareholder rights plans are a legitimate, and effective, weapon in a potential target's arsenal of takeover defenses

Since my invention of the rights plan in 1982,[9] we have witnessed extensive, and at times heated, debate and discussions on issues ranging from the ideological

5 *See* Unocal Corp v Mesa Petroleum Corp , 493 A 2d 946, 955 (Del 1985) (referencing Martin Lipton & Andrew R Brownstein, *Takeover Responses and Directors' Responsibilities An Update*, ABA NAT'L INST ON THE DYNAMICS OF CORP CONTROL 7 (1983)) Subsequent jurisprudence, both in Delaware and in other jurisdictions, also supports the idea that constituencies other than shareholders may be factors in a board's decisionmaking *See, e g* , Gelco Corp v Coniston Partners, 652 F Supp 829 (D Minn 1986) *aff'd in part, vacated in part*, 811 F2d 414 (8th Cir 1987), GAF Corp v Union Carbide Corp , 624 F Supp 1016 (S D N Y 1985)

6 493 A 2d at 954

7 *See* Moran v Household Int'l, Inc , 500 A 2d 1346 (Del 1985)

8 *See, e g* , Quickturn Design Sys , Inc v Shapiro, 721 A 2d 1281 (Del 1998) (striking down a delayed redemption no-hand pill provision), Carmody v Toll Bros , Inc , 723 A 2d 1180 (Del Ch 1998) (ruling that a claim challenging the validity of a dead-hand pill provision could survive a motion for summary judgment)

9 Martin Lipton, *Discussion Memorandum Warrant Dividend Plan* (Sept 15, 1982) The name "warrant dividend plan" was changed to "shareholder rights plan" to satisfy New York Stock Exchange listing requirements (on file with author)

to the pragmatic—from challenges to rights plans as violative of fundamental shareholder rights to debates regarding the effect of a rights plan on shareholder value I will not retrace these in this essay (as they have been well articulated elsewhere) and will state only that I am not alone in extolling the virtues of rights plans and the contributions to shareholder value made by a board that implements and administers takeover defenses in a manner consistent with its business judgment For example, a February 2004 study released by Institutional Shareholder Services and Georgia State University found that companies with strong takeover defenses, including rights plans, generally demonstrated higher shareholder returns, stronger profitability measures, higher dividends and stronger financial indicators than companies without such defenses [10] Moreover, some of the more ardent opponents of board action in the face of takeovers—those that advocated director passivity so as not to interfere with "efficient markets"—have revisited their theories in light of recent empirical evidence [11] But even some of those who continue to part company with me with respect to the most fundamental theories behind the pill would agree that the pill's development has had a profound impact on corporate practice Professor Ronald Gilson, for example, has stated that "Martin Lipton has a strong claim to having devised the most important innovation in corporate law since Samuel Dodd invented the trust for John D Rockefeller and Standard Oil in 1879."[12]

In a 1981 update to *Takeover Bids*, I pointed to McGraw-Hill's rejection in 1979 of a $40 per share offer by American Express (which at that time represented a 50% premium over the pre-offer market price of $26), noting that, within less than two years, "the directors' decision was completely vindicated with the shares selling in the market for more than the $40 per share offer price."[13] Although some "efficient markets" theorists dismissed McGraw-Hill's post-1979 value creation as "luck of the draw,"[14] the graph below, showing the rise in the company's stock price over the past twenty-five years, indicates otherwise It is far from mere serendipity that, from January 1979 until December 2004, the market capitalization of McGraw-Hill rose from $806 million to over $17 billion

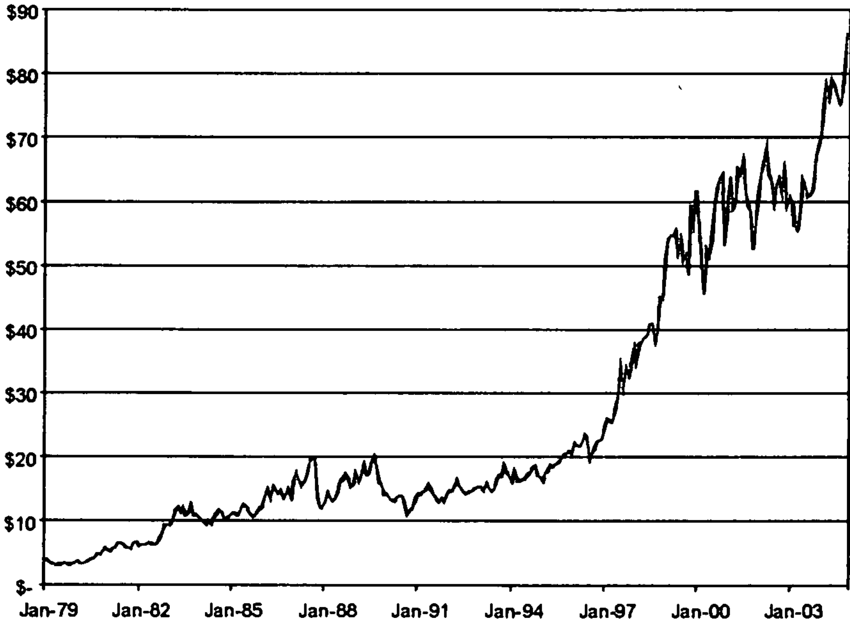
10 Lawrence D Brown & Marcus Caylor, Institutional Shareholder Services, Corporate Governance Study The Correlation Between Corporate Governance and Company Performance (2004)

11 For example, Michael Jensen, formerly a vigorous proponent of "efficient markets," now subscribes to what he terms the "enlightened stakeholder theory"—a proposition that, to maximize long-term market value maximization, boards must consider the perspective of all corporate stakeholders *See* Michael C Jensen, Value Maximization, Stakeholder Theory and the Corporate Objective Function (Harv Bus Sch , Negotiation, Organization and Markets Unit, Working Paper No 01-01, 2001)

12 Ronald J Gilson, *Lipton and Rowe's Apologia for Delaware A Short Reply*, 27 Del J Corp L 37, 37 (2002)

13 Martin Lipton, *Takeover Bids in the Target's Boardroom An Update After One Year*, 36 Bus Law 1017, 1026 (1981)

14 Frank H Easterbrook & Daniel R Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 Bus Law 1733, 1742 (1981)



The academic debate over the board's role in the context of a takeover, and related debates over shareholder rights plans and constituency concerns, will continue for as long as there is an audience—and there will always be an audience There is little doubt, however, that the concept of the board as gatekeeper—and deference to board decisions made in accordance with common law standards—is now well established, and that the concept of director passivity in the face of a tender offer has been rejected by both legislatures and the common law In short, the first battle has been won

II. New Battles and the Continuing War

Those of us who ascribe to the theories espoused in *Takeover Bids* should thus be pleased with the developments of the past twenty-five years But new, and perhaps more dangerous, battles await us The burst of the "Millennium Bubble" of the late 1990s and early 2000s, and the ensuing collapse of corporate giants such as Enron and WorldCom, created a crisis in investor confidence and placed an overwhelming focus on the failures of corporate fiduciaries. The regulatory response to this crisis was immediate and far-reaching and has permanently raised the bar for corporate America in terms of transparency, accountability and performance The crisis also has, however, emboldened certain self-proclaimed shareholder activists, populist politicians, labor unions and other special-interest shareholders to advocate even more aggressive regulatory measures and unprecedented levels of personal liability for directors, all with the purported goal of restoring

trust in corporate America At the level of state common law, these messages are in danger of being reinforced by new, more expansive theories of director accountability and liability These "initiatives" and trends represent a dangerous—and far more wide-reaching—rebirth of the director passivity concept If successful, they threaten to transform directors from active managers to merely risk-averse facilitators of institutional shareholder dictates, and as such they pose a genuine threat to the fundamental fabric and structure of the American enterprise

A. Regulatory Zeal and "Activism" Gone Awry

The initial regulatory response of lawmakers and the stock markets in the wake of the Enron and WorldCom scandals reflected the sense of urgency that permeated public discourse The Sarbanes-Oxley Act of 2002[15] and accompanying SEC rules, as well as newly enacted rules of the major stock markets,[16] sought to establish a framework for restoring public confidence The new NYSE rules, which focused on creating independent, active boards and improving the dialogue between a company and its shareholders, re-shifted the tone and focus of the boardroom toward independence and careful oversight The Sarbanes-Oxley Act, in turn, in large part has succeeded in establishing a regime of corporate accountability, enhancing disclosure, improving the quality and transparency of financial reporting and auditing and establishing oversight of public company auditors

The product of this regulatory zeal was, however, in part extreme Sarbanes-Oxley was enacted in haste, and has become the basis for efforts to place a federal overlay on traditional state corporate governance In this way, some have turned recent regulations into yet another iteration of the director passivity argument As Chancellor Chandler and Vice-Chancellor Strine of the Delaware Court of Chancery rightly observed

> [The 2002 reforms] represent a marked increase in federal government and [stock exchange] regulation of the corporate boardroom [They] prescribe a host of specific procedures and mechanisms that corporate boards must employ in the governance of their firms These prescriptions impinge on the managerial freedom permitted to directors by state corporation law [17]

We have yet to witness the full effects of the 2002 reforms on state corporation law but should remain keenly aware of their potential to corrode the statutory fabric that has heretofore governed director conduct

A more immediate danger, however, arises from the self-proclaimed "activists" (including public pension funds, labor unions and academics) who are seeking to rekindle the notion of director passivity by proposing initiatives to restrict further the board's management discretion A number of post-Sarbanes-Oxley

15 Pub L No 107-204, 116 Stat 745

16 *See, e g*, NYSE, Inc, Listed Company Manual § 303A (2005), National Association of Securities Dealers, Inc, NASD Manual, Marketplace Rules, Rule 4350 (2005)

17 William B Chandler III & Leo E Strine, Jr, *The New Federalism of the American Corporate Governance System Preliminary Reflections of Two Residents of One Small State*, 152 U Pa L Rev 953, 958 (2003)

governance proposals seek to dictate excessively stringent board selection criteria and to impose highly detailed requirements as to key aspects of governance that traditionally have fallen within the purview of the board These proposals include, for example, requiring the entirety of the board to be independent,[18] a continued emphasis on separating the roles of chairman and chief executive officer,[19] stringent limits on the amount and form of executive compensation[20] and unrealistic responsibility for accounting and risk management matters It would be a mistake to shift the regulatory focus toward such over-engineering of board structure, composition and responsibilities or toward bright-line limitations on executive compensation Independence is an essential component of a successful board, but so are collegiality, experience, sense of common purpose and trust Each company, through its independent nominating committee, is in the best position to determine the most suitable mix of attributes for its board Similarly, each company, through its independent compensation committee, should determine the most desirable compensation structure for members of its senior management. Indeed, decisions such as these are at the core of the board's oversight and gatekeeping function.

Equally dangerous is the increasingly vocal discourse—through legislative, academic and purportedly "grassroots" efforts—on shareholder "empowerment," which in my view is nothing short of an attack on the most basic principles underlying the American corporation [21] Two examples can illustrate this disconcerting trend the SEC's 2003 proposal to grant shareholders the ability to use a company's proxy statement for director nominations[22] and the increased and direct pressure from shareholder groups to influence the company's day-to-day management

Contrary to the claims of activist institutional shareholders and shareholder advisory firms, shareholder access to the proxy statement is not a question of correcting shareholder disenfranchisement. Shareholders' viewpoints currently are voiced, heard and respected Shareholders currently have the right and the ability to communicate with the board's nominating committee, place advisory resolutions in the company's proxy statement, withhold votes for directors and conduct a traditional proxy fight to elect either a full or short slate of directors

18 *See, e g*, RICHARD C BREEDEN, RESTORING TRUST REPORT TO THE HON JED S RAKOFF, THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK, ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC (2003), *available at* http //www concernedshareholders com/CCS_MCI_BreedenReport pdf

19 *See, e g*, CAROLYN KAY BRANCATO & CHRISTIAN A PLATH, THE CONFERENCE BOARD, CORPORATE GOVERNANCE BEST PRACTICES A BLUEPRINT FOR THE POST-ENRON ERA (2003)

20 *See, e g*, *Executive Compensation & the Boardroom Dilemma*, 115 US BANKER 32 (Nov 1, 2005), *available at* 2005 WLNR 1762775

21 For a recent manifestation of such academic theories, see Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV L REV 833 (2005) (arguing for shareholder "empowerment" with respect to virtually all key aspects of corporate management, including "rules of the game" decisions (such as changes in the company's charter or jurisdiction of incorporation), "game-ending decisions" (such as a company's decision to merge, sell all assets or dissolve) and "scaling-down decisions" (such as cash dividends or in-kind distributions))

22 Security Holder Director Nominations, SEC Release No 34-48626 (2003), *available at* http //www sec gov/rules/proposed/34-48626 htm

Granting shareholders access to a company's own proxy statement to seek to substitute the shareholders' nominees for the company's, however, would go far beyond merely granting shareholders a stronger voice. It would result in a significant increase in election contests sponsored by special-interest shareholders It would introduce an atmosphere of tension and distrust between shareholders and directors and management And it would radically change the dynamic of corporate governance by, among other things, threatening the collegiality of boards and introducing special-interest "gadflies" with agendas that are distinct from, and indeed may be contrary to, the interest of the company as a whole or of the company's other shareholders [23] As I discussed in a recent article.

> [T]he shareholder as owner, principal-agent model is a flawed model as applied to the modern public company It does not provide an affirmative basis for the adoption of [shareholder access] proposals. In contrast, the costs of adopting such a proposal are real and substantial In the context of a newly adopted regulatory framework that is already designed to address the issues of board composition and director performance, the adoption of proposals to facilitate election contests is an unwarranted step that offers little apparent benefit and threatens significant harm As it has in the past, the SEC should weigh these costs against the absence of any clear benefit and reject these proposals [24]

We also must strongly guard against special-interest shareholders who seek to conquer the corporate boardroom with their personalized agendas Labor unions, public pension funds and other special-interest groups are actively using withhold-the-vote campaigns as a means to exercise pressure on boards to conduct their affairs in the manner desired by those shareholders—without consideration, perspective or even interest in the long-term interests of the corporation and its shareholders as a whole Not satisfied with a company's commitment and obligation to adhere to the current regulatory environment, special-interest shareholders have threatened to withhold votes for directors who fail to satisfy their own personal set of "good governance" requirements of, *inter alia*, independence, "conflicts" or presence on other company boards, as well as for directors who serve on compensation committees where these shareholders believe there is a disconnect between the CEO's pay and performance [25] Special-interest shareholders have also threatened to withhold votes in connection with, and have presented shareholder resolutions that challenge, among other things, board decisions regarding accounting principles, shareholder rights plans, the preservation of a clas-

23 For a discussion of the dangers and conceptual inconsistencies of "empowering" institutional shareholders, see Roberta S Karmel, *Should a Duty to the Corporation Be Imposed on Institutional Shareholders?*, 60 BUS LAW 1 (2004)

24 Martin Lipton & Steven A Rosenblum, *Election Contests in the Company's Proxy An Idea Whose Time Has Not Come*, 59 BUS LAW 67, 94 (2003)

25 *See* Institutional Shareholder Services, *ISS Domestic Corporate Governance Policy, 2005 Updates, available at* http://www issproxy com/pdf/MVPolicy Update pdf, *see also Calpers Asks CEOs for Information on Directors, Managers Who Hold Stock in Service Providers*, CORPORATE GOVERNANCE HIGHLIGHTS (IRRC, Washington, D C) Nov 5, 2004, at 255

sified board, refusal to separate the officers of CEO and Chairman of the Board and refusal to implement past shareholder proposals.[26] Some academics recently have joined this falsely labeled "shareholder empowerment" chorus, arguing that essentially all key decisions relating to the existence and operations of the corporation should be made directly by shareholders—with little role for the board other than that of a passive observer In an almost stereotypical (yet quite dangerous) academic's elevation of agency theory to the ridiculous, Professor Lucian Bebchuk of Harvard Law School recently has argued for the equivalent of governance by referendum, completely dismissing the oversight and gatekeeper role of the board [27]

Proponents of these "initiatives" fail to comprehend—or, if they do comprehend, they erroneously challenge—the most fundamental building blocks of the American corporation Contrary to what Professor Bebchuk advocates, corporations are by definition not entities in which all actions require a vote by or sign-off from each member Nor are corporations intended to be governed through "town meetings " Instead, corporations are designed to be risk-taking collections of capital in which those putting in the capital—the shareholders—surrender day-to-day control of the corporation but are granted immunity from liability as a way of encouraging risk Other organizational forms—such as partnerships and limited liability companies—are available to investors who seek the level of micro-management that Professor Bebchuk and others seem to advocate One can assume that if these organizational forms were equally wealth- and value-creating, they would be more prevalent in the American economy

The late Sumantra Ghoshal, of the Advanced Institute of Management Research and London Business School, put forward what in my opinion is the most cogent refutation of Professor Bebchuck's agency-theory-statistical-based corporate governance arguments and strong support for the basic premises of *Takeover Bids*

26 *See* Institutional Shareholder Services, *supra* note 25 If directors want to preserve their role as active gatekeepers and guardians of the best interests of the corporation and its shareholders, they will have to face the threat of a "withhold" vote campaign and/or these shareholder resolutions They must be prepared to conduct an active proxy solicitation to explain their position to shareholders, and even experience a significant "withhold" vote or approval of an opposing shareholder resolution, but continue to pursue what they in their business judgment believe to be in the best interests of the corporation Even if a majority of the outstanding shares withhold their votes, the directors would still be reelected as long as they receive a majority of the votes actually cast, without regard to the "withhold" votes This appears to be the impetus behind the proxy resolution campaign, led by special interest shareholders, to change the election process from plurality to majority, and for these groups' support of, the SEC's proposed rule granting shareholder access triggered by 30% of the shares withholding their votes for directors

27 *See* Bebchuk, *supra* note 21 Not only does Professor Bebchuk take his agency theory arguments to the extreme in arguing for shareholder dominance, but he also seems to ignore the vast agency issues surrounding the very shareholders he seeks to empower Even putting aside the union- or politician-run pension fund, in an era when institutional shareholders own large stakes in most American corporations, Professor Bebchuk does not explain why he believes the management of proxy advisory firms (to which many institutional shareholders have delegated their voting authority over many key governance and transactional issues) might be a better-informed decision-maker for thousands of corporate enterprises than the individual boards of directors of those corporations To whom are such proxy advisory firms truly accountable, and should they be subject to the SEC proxy rules?

> Why do we not fundamentally rethink the corporate governance issue? Why don't we actually acknowledge in our theories that companies survive and prosper when they simultaneously pay attention to the interests of customers, employees, shareholders, and perhaps even the communities in which they operate? Such a perspective is available, in stewardship theory for example , why then do we so overwhelmingly adopt the agency model in our research on corporate governance, ignoring this much more sensible proposition?
>
> The honest answer is because such a perspective cannot be elegantly modeled—the math does not exist Such a theory would not readily yield sharp, testable propositions, nor would it provide simple, reductionist prescriptions With such a premise, the pretense of knowledge could not be protected Business could not be treated as a science, and we would have to fall back on the wisdom of common sense that combines information on "what is" with the imagination of "what ought to be" to develop both a practical understanding of and some pragmatic prescriptions for "phenomena of organized complexity" that the issue of corporate governance represents [28]

B. Personal Attacks on Directors

Recent attacks on the American corporation have not been limited to rulemaking and voting procedures These same shareholder "activists," joining forces with plaintiff's lawyers and regulators and prosecutors with political ambitions, are seeking to capitalize on certain egregious examples of alleged failure of directors as gatekeepers to establish a regime in which directors may at any time be held personally liable for corporate wrongdoing—and in which the threat of personal liability ostensibly would terrorize directors into not misbehaving The SEC Staff, as well as state prosecutors, are pursuing actively a philosophy that "[e]ffective deterrence requires personal accountability"[29] The plaintiffs in the recent WorldCom settlement (which, if approved by the court, will require WorldCom directors to pay a total of $20 25 million from their personal funds in settlement of claims relating to alleged violations of the federal securities laws) more than just echoed this principle In a press release announcing the initial WorldCom directors' settlement, New York State Comptroller Alan Hevesi stated that the shareholder plaintiffs' intent was to communicate to directors that they may be held personally liable "if they *allow* management of the companies on whose boards they sit to commit fraud "[30] This comment by an elected manager of a public pension fund

28 Sumantra Ghoshal, *Bad Management Theories Are Destroying Good Management Practices*, 4 ACAD OF MGMT & EDUC 75, 81 (2005)

29 Kara Scannell & Deborah Solomon, *Your Fault Directors' Payback Deal Shows Corporate Boards Aren't Safe*, WALL ST J , Jan 7, 2005, at C1 (quoting Stephen Cutler, Director of the SEC's Division of Enforcement)

30 Press Release, Office of Alan G Hevesi, New York State Comptroller, Hevesi Announces Historic Settlement, Former WorldCom Directors To Pay From Own Pockets Case Continues to Trial Against Remaining Underwriter Defendants, Arthur Andersen & 2 Remaining Director Defendants (Jan 7, 2005), *available at* http //www osc state ny us/press/releases/jan05/010705 htm (emphasis added)

conveys a tremendous sense of uncertainty for directors and would, if heeded, impose a standard of conduct that would be impossible to implement fairly in practice One can imagine a range of unintentional, and perhaps even ordinary course, director actions that would be alleged by shareholder plaintiff, in varying types of litigation contexts, as evidence of a director *allowing* management to misbehave

This same trend is appearing at the state common law level, where arguments for personal liability for directors center on allegations of breaches of the "duty of good faith" Breach of the "duty of good faith" has long been held to deny directors the protection of the business judgment rule and exculpation, indemnification and insurance.[31] Now, in situations where the directors were, or could be alleged to have been, negligent or inattentive, the plaintiffs are alleging breach of the "duty of good faith," as well as the duty of care, in order to threaten removal of all protection against personal liability and thereby assert maximum pressure on the directors to settle In the recent Disney and Abbott Laboratories litigations, courts found that plaintiffs adequately pled allegations of breaches of the "duty of good faith," and that these allegations were sufficient not only to survive a motion to dismiss, but also to bring any such claims outside the protections of any statutorily-permitted charter exculpation provision [32] In the Disney case, in denying a motion to dismiss the plaintiffs' amended complaint, the Delaware Court of Chancery held that directors could be held personally liable if they committed aggravated negligence, even though they obtained no improper personal benefit and acted without any conflicting personal interest in the matter at issue The Court ruled that plaintiffs could recover damages from the directors personally if they could prove at trial that the directors' lack of attention to key negotiations and decisions relating to the hiring and compensation package of the company president amounted to a lack of "good faith" The court ruled that this aggravated negligence (consisting of an alleged "conscious[] and intentional[] disregard" by the board of its responsibilities and a "we don't care about the risks" attitude regarding the hiring and compensation discussions), if proven, would essentially constitute bad faith Although the Court in Disney allowed the litigation against the Disney directors to proceed, the Court ultimately ruled that the Disney directors did not breach their fiduciary duties in the 1995 hiring and 1996 termination of Michael Ovitz In so doing, the Court reaffirmed fundamental concepts of the business judgment rule, stating that aspirational "best practices" are not synonymous with legal requirements that would result in liability for directors, and that directors must have the freedom to act, within the boundaries of their fiduciary duties, "as their judgment and abilities dictate, free of *post hoc* penalties from a reviewing court using perfect hindsight "[33]

31 *See generally*, Lisa M Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liabilities*, 42 HOUS L REV 393 (2005)

32 *See In re* Abbott Lab Derivative S'holder Litig , 325 F3d 795 (7th Cir 2003), *In re* The Walt Disney Co Derivative Litig , 825 A 2d 275 (Del Ch 2003)

33 *In re* The Walt Disney Co Derivative Litig , No CivA 15452, 2005 WL 2056651, at *1-2 (Del Ch Aug 9, 2005)

It is too early to tell how, or whether, attempts to use the "duty of good faith" to undermine director protection against personal liability will be actualized, and whether the class action and SEC settlements that have occurred to date and involved personal liability for directors are representative of a new regime. What we can assume, however, is that establishing a default regime where directors are held personally liable in damages—or where directors are intimidated into settling shareholder lawsuits—will not serve the purpose of improving corporate governance, but rather will have a chilling effect. Post-Enron regulations have already caused boards to overemphasize the monitoring of compliance at the expense of providing strategic advice on business issues. Concerns about personal liability will result in an even greater shift by boards to process, rather than strategy and performance. And faced with potential personal liability if their actions are misinterpreted or mischaracterized, directors will likely hesitate to take risks, to explore the uncertain and generally to explore fully all means to derive short- and long-term shareholder value. Moreover, a "good faith" requirement that becomes an end-run around duty of care jurisprudence will elevate negligence into malfeasance and vitiate all the policy reasons underlying the traditional business judgment rule. In short, the threat of unwarranted personal attacks on directors will have grave consequences on the entrepreneurial spirit that is the very foundation of effective board governance.[34]

Central to many of these "empowerment" and director liability arguments is an exaltation of agency theory with a concomitant distrust of the corporate director, and the assumption that directors will, as a matter of course, neglect their fiduciary duties in favor of self-interest. Although recent scandals such as Enron and WorldCom have suggested that some directors may have done exactly that, we should not lose sight of the fact that these were egregious cases, and that for years American corporations, and the American economy, have prospered mightily and to the envy of the world under a regime that entrusts a board of directors with the responsibility and authority to oversee the corporation in accordance with shareholders' and the corporation's best interests. Bad facts should not make bad law, or bad governance goulashes.

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34 Recognizing these dangers, in a recent speech, former Delaware Chancellor William T. Allen proposed that Delaware's statutory exculpation provision be amended to clarify that it applies to any loss arising from a board decision in which there is no conflict of interest (including negligence of the type alleged in the Disney and Abbott Laboratories cases). Former Chancellor Allen commented:

> An amendment of Section 102(b)(7) to allow shareholders the right to waive damages for claims of inattention of whatever degree and however couched would be a wholesome signal to corporate America in my opinion. It would not be a sign that Delaware law seeks to encourage the return of the passive boards of the past. That era is over and not because the law of director liability that has changed it. But if we recognize the shareholder protective effect of the business judgment rule, we are likely I think to see the restoration of the spirit of the business judgment rule to its historic place in Delaware corporation [law] as a beneficial improvement in our corporate governance system. Amendment of Section 102(b)(7) is an important step in that direction.

William T. Allen, Shareholder Welfare and the Eroding Business Judgment Rule, Remarks before the Delaware Corporate Law Conference (May 11, 2005) (transcript on file with author).

In the words of Peter Drucker, "the Enterprise can be said to be the one innovation that created the Modern Economy—far more so than any other invention, whether material or conceptual "[35] The American enterprise is the systematic risk-taker and risk-sharer" of our economy—the primary means through which wealth and prosperity are generated on a macroeconomic level Central to this structure is a delicate interrelationship among the enterprise, the CEO (who manages it), the board of directors (which oversees its management) and shareholders and society at large (who benefit from it) If special-interest shareholders and other "activists" prevail in their latest battle—that is, if additional, more demanding governance and "shareholder empowerment" measures and personal liability for directors become integrated into the regulatory and common law landscape—we will have altered the structure of the enterprise and moved toward excising the board from its principal role Not only will the board as an institution suffer from the curtailment of its ability to manage the corporation, but we will not be able to attract competent, responsible people to serve as directors of public companies [36] Moreover, faced with a punitive regime that could extend to any perceived failure of a director (whether or not intentional and whether or not egregious), the people who do serve on boards will focus on their self-protection, and will be hesitant to take risks that may benefit the corporation As Treasury Secretary John Snow recently remarked, "some investments that should have been undertaken, that would have been good for society, good for investors, good for shareholders, and good for the economy's growth, won't be undertaken "[37] In short, director passivity will have triumphed over the entrepreneurialism that has always been at the heart of the business judgment rule We must all brace ourselves for this next battle And we must do all we can to ensure that the train does not fly off the tracks

35 Peter F Drucker, *The American CEO*, WALL ST J , Dec 30, 2004, at A8

36 As noted in a recent editorial in *The Economist*, "striking the right balance is difficult If a flood of lawsuits now target directors' personal assets, the supply of good directors is bound to dry up, and that would harm shareholders themselves most of all " *See Stick 'Em Up Should Board Directors Be Forced To Dig Into Their Own Pockets To Settle Shareholder Lawsuits?*, ECONOMIST, Jan 15, 2005, at 12

37 Beth Belton, ed , *Newsmaker Q&A Sarbanes-Oxley A Sense of "Siege"* BUSINESS WEEK ONLINE, (Jan 6, 2005), *available at* http//www businessweek com/bwdaily/dnflash/jan2005/nf2005016_3280_db052 htm